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# In The Supreme Court of the United States

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NAVEEN JAIN AND ANURADHA JAIN,
*Petitioners,*

v.

J.P. MORGAN SECURITIES, INC.,
WILSON SONSINI GOODRICH & ROSATI, P.C.,
AND PERKINS COIE, LLP,
*Respondents.*

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ON PETITION FOR A WRIT OF CERTIORARI
TO THE COURT OF APPEALS
FOR THE STATE OF WASHINGTON

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## PETITION FOR A WRIT OF CERTIORARI

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## QUESTION PRESENTED

Section 16(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78p(b)) ("16(b)") imposes "strict-liability" on insiders who engage in "short-swing" trades of company securities. The Jains were found strictly liable under 16(b). After satisfying their 16(b) liability to the issuer, they sued to recover their losses to the extent they were the result of Respondents' negligence. Below, the Court of Appeals affirmed dismissal of the Jains' state law claims, holding they were barred, as a matter of law, by a federal policy against "de facto indemnification" for liability imposed by the federal securities laws.

The question presented is:

Whether securities professionals can escape liability for their clients' losses on federal policy grounds where the objectives of the securities statute under which their clients' loss occurred were satisfied and the professionals' negligence caused those losses.

## PARTIES TO THE PROCEEDING

Petitioners are Naveen and Anuradha Jain, a married couple. They were plaintiffs in Superior Court, and appellants in both the Court of Appeals and Supreme Court for the state of Washington.

Respondents are J.P. Morgan Securities, Inc., Wilson Sonsini Goodrich & Rosati, P.C., and Perkins Coie, LLP. They were defendants in Superior Court and respondents in both the Court of Appeals and Supreme Court for the state of Washington.

TABLE OF CONTENTS


Page

Question Presented ..... i

Parties to the Proceeding ..... ii

Table of Authorities ..... vi

Petition for Writ of Certiorari ..... 1

Opinion Below ..... 1

Jurisdiction ..... 1

Statutory Provision Involved ..... 2

Statement of the Case ..... 3

I. Factual Background ..... 4

A. The Parties ..... 4

B. The Securities Transactions at Issue in the 16(b) Litigation ..... 6

1. The False Footnote in the InfoSpace IPO Prospectus ... 6

2. The Misdeposits of Trust Shares into the Jains' Personal Account ..... 6

C. The 16(b) Litigation ..... 7

II. Proceedings Below ..... 10

A. Filing, Removal and Remand ..... 10

B. Superior Court ..... 12

C. Court of Appeals ..... 14

D. State Supreme Court ..... 15

Reasons for Granting the Writ ..... 15

I. The Circuits Are Split ..... 17

II. This Court's 16(b) Decisions ..... 30

A. *Reliance Electric* ..... 30

B. *Kern County* ..... 33

C. *Foremost-McKeeson* ..... 35

III. Claims to Apportion Damages for Violations of the Federal Securities Laws Based on Fault Should Be Treated Uniformly ..... 36

Conclusion ..... 40

## APPENDICES

### STATE SUPREME COURT ORDER

Appendix A (Order) (October 1, 2008)..... A-1

### COURT OF APPEALS ORDER

Appendix B (Order) (January 14, 2008)
*reported at* 177 P.3d 117 (Wash. Ct. App. 2008) ..... A-3

### SUPERIOR COURT ORDER

Appendix C (Orders) (May 4, 2006)..... A-19

### DISTRICT COURT ORDERS

Appendix D (Order) (January 9, 2004)
2004 WL 212999 ..... A-31

Appendix E (Judgment) (August 22, 2003)
*Dreiling v. Jain,* 281 F.Supp.2d 1234 (W.D.Wash. 2003) ..... A-44

Appendix F (Order) (May 14, 2003)
*Dreiling v. Kellett, et al.,* 281 F.Supp.2d 1215 (W.D.Wash. 2003) ..... A-60

## TABLE OF AUTHORITIES

Page

CASES:

*AAL High Yield Bond Fund v. Deloitte & Touche, LLP*, 361 F.3d 1305 (11th Cir. 2004) ..... 27

*Arden Way Assoc. v. Boesky*, 664 F. Supp. 863 (S.D.N.Y. 1987) ..... 20

*Baker, Watts & Co. v. Miles & Stockbridge*, 876 F.2d 1101 (4th Cir. 1989) ..... 21

*Bershad v. McDonough*, 428 F.2d 693 (7th Cir. 1970) ..... 32

*Bunker Ramo-Eltra Corp. v. Fairchild Indus., Inc.*, 639 F.Supp. 409 (D. Md. 1986). ..... 25

*Cambridge Fund, Inc. v. Abella*, 501 F.Supp. 598 (S.D.N.Y. 1980) ..... 19

*Eichenholtz v. Brennan*, 52 F.3d 478 (3d Cir. 1995) ..... 28

*First Golden Bancorp. v. Weiszmann*, 942 F.2d 726 (10th Cir. 1991) ..... 18, 24, 26, 29

*Foremost-McKeeson, Inc. v. Provident Sec. Co.*, 423 U.S. 232, 96 S.Ct. 508, 46 L.Ed.2d 464 (1976) ..... 35

*Fromer v. Yogel*, 50 F.Supp.2d 227 (S.D.N.Y. 1999) ..... 20

*Globus v. Law Research Serv. Inc.*,
418 F.2d 1276 (2d Cir. 1969), *cert. denied*,
397 U.S. 913 (1970) ..... 19, 25, 29

*Greenwald v. American Medcare Corp.*,
666 F.Supp. 489 (S.D.N.Y. 1987) ..... 20

*Happ v. Corning, Inc.*,
466 F.3d 41 (1st Cir. 2006) ..... 29

*Heizer Corp. v. Ross*,
601 F.2d 330 (7th Cir. 1979) ..... 22, 23

*Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 378 F.Supp. 112
(S.D.N.Y. 1976) ..... 19

*In re Cendant Corp. Sec. Litig.*,
139 F. Supp. 2d 585 (D.N.J. 2001) ..... 29

*In re Sunrise Sec. Litig.*,
793 F.Supp. 1306 (E.D.Pa. 1992) ..... 29

*In re U.S. Oil & Gas Litig.*,
967 F.2d 489 (11th Cir. 1992) ..... 26, 27

*In re XO Communications, Inc.*,
330 B.R. 394 (S.D.N.Y. 2005) ..... 25

*Kern County Land Co. v. Occidental Petroleum Co.*,
411 U.S. 582, 93 S.Ct. 1736,
36 L.Ed. 503 (1973) ..... 33, 36

*King v. Gibbs*,
876 F.2d 1275 (7th Cir. 1989) ..... 22

*Laventhol, Krekstein, Horwath & Horwath v. Horwitch*, 637 F.2d 672 (9th Cir. 1980) ... 23

*Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286, 113 S. Ct. 2085, 124 L.Ed.2d 194 (1993) ..... 36, 38

*Professional Beauty Supply, Inc. v. National Beauty Supply, Inc.*, 594 F.2d 1179 (8th Cir. 1979) ... 29

*Raychem Corp. v. Fed. Ins. Co.*, 853 F. Supp 1170 (N.D. Cal. 1994) ... 24, 29

*Reliance Electric Co. v. Emerson Electric Co.*, 404 U.S. 418, 92 S.Ct. 596, 30 L.Ed.2d 575 (1972) ..... 30, 35, 36

*Schaffer v. CC Invs., LDC*, 286 F. Supp. 2d 279 (D.N.Y., 2003) ..... 25

*Stowell v. Ted S. Finkel Investment Services*, 641 F.2d 323 (5th Cir. 1981) ..... 29

*Texas Indus., Inc. v. Radcliff Materials, Inc.*, 451 U.S. 630, 101 S.Ct. 2061, 68 L.Ed.2d 500 (1981) ..... 22

STATUTES:

15 U.S.C. § 78p(b) ..... *passim*

15 U.S.C. § 78u-4 ..... 37

28 U.S.C. § 1257 ..... 1

28 U.S.C. § 2101 ..... 2

COURT RULES

Supreme Court Rule 13.1 ..... 2

OTHER AUTHORITIES:

Deborah A. DeMott,
*Shareholder Deriv. Actions L. & Practice*,
§ 6:43 (2008)..... 18

H.R. Conf. Rep. No. 104-369 (1995),
*reprinted in* 1995 U.S.C.C.A.N. 730 ..... 37

## PETITION FOR WRIT OF CERTIORARI

The Jains respectfully petition the Court for a writ of certiorari to the Washington State Court of Appeals (review denied by the Washington State Supreme Court). That court held that a federal policy against "de facto indemnity" immunized securities professionals from liability to their client where their negligent conduct created the very transactions that led to the Jains' strict liability for "short-swing" trading under Section 16(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78p(b)) ("16(b)"), and immunized the lawyers whose negligence and conflicts of interest resulted in a ruling of 16(b) liability. The Jains were unaware of the short-swing transactions, had settled the 16(b) judgment by paying the issuer, and sought only to allocate their losses according to fault under well-recognized principles of state law.

## OPINION BELOW

The decision of the Washington State Court of Appeals (App. B) for which this Petition is filed is reported at 177 P.3d 117 (Wash. Ct. App. 2008).

## JURISDICTION

The jurisdiction of this Court is invoked under 28 U.S.C. § 1257, which provides that "Final judgments or decrees rendered by the highest court of a State in which a decision could be had, may be reviewed by the Supreme Court by writ of certiorari where the validity of a treaty or statute of the United States is drawn in question[.]" On October 1, 2008, the Washington State Supreme Court issued

an order (App. A) denying Petitioners' Petition for Review, rendering the Court of Appeals' January 14, 2008 order (App. B) a "final judgment" rendered by the highest Washington State court "in which a decision could be had." This Petition is timely under 28 U.S.C. § 2101 and Supreme Court Rule 13.1.

## STATUTORY PROVISION INVOLVED

Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b), states:

> **Profits from purchase and sale of security within six months**
> For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) or a security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) involving any such equity security within any period of less than six months, unless such security or security-based swap agreement was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security or

security-based swap agreement purchased or of not repurchasing the security or security-based swap agreement sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security or security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

## STATEMENT OF THE CASE

Petitioners request that this Court grant a writ of certiorari to review a decision of the Washington State Court of Appeals.

This case raises unsettled issues of the extent to which negligent securities professionals are protected, by a federal policy against "de facto indemnity," from liability they would otherwise have under state law for losses their client suffered. The Circuits are divided on whether and to what extent the Securities Exchange Act of 1934 (the "1934 Act") bars such actions. Specifically, this case presents the question whether securities professionals whose negligence a) created short-swing trades and b) in one case created the appearance of a short-swing trade that did not actually occur, are immunized from liability by a federal "anti-indemnity" rule where the insider held liable for such trades under Section 16(b) of the 1934 Act (15 U.S.C. § 78p(b)) was not even aware of the actions that created the transactions or of the false statements that created the appearance of a transaction that did not occur. While this case arises under 16(b), the "de facto indemnity" issue has also frequently arisen under other provisions of the 1934 Act and the Securities Act of 1933 (the "1933 Act"). This Court has not ruled on the existence or scope of such a bar to state law claims, and the Circuits are divided.

## I. Factual Background

### A. The Parties

The Jains founded InfoSpace, Inc. in 1996 and received "Founders" shares of InfoSpace stock at that time. Later, they established three trusts to benefit their children, and funded them with InfoSpace stock.

InfoSpace completed its IPO in December 1998. Respondents J.P Morgan Securities, Inc. ("Morgan"), Wilson Sonsini Goodrich & Rosati, P.C. ("Wilson"), and Perkins Coie LLP ("Perkins") were responsible for preparing the IPO Prospectus as lead underwriter, counsel for the underwriter, and counsel for InfoSpace, respectively. Morgan also was the Jains' personal securities broker. Respondents each took actions that, individually or collectively, created "purchases" by the Jains of the trusts' InfoSpace shares or the appearance of such purchases – by misdepositing trust shares into the Jains' personal investment account and by inserting into the IPO Prospectus a footnote containing a false statement regarding creation of an escrow with trust shares, as discussed below.

Years after the IPO, a shareholder sued the Jains for "short-swing" trading under 16(b), based on sales by the Jains of some of their Founders' shares within six months after "purchases" that were held to have occurred by reason of the false footnote and misdeposits. The Jains were unaware of the misdeposits. The footnote described an event that never actually occurred. In the 16(b) litigation, Perkins represented the Jains as defense counsel. Perkins had conflicts both because it also represented InfoSpace (the direct beneficiary of any judgment against the Jains) in other matters and because it was a co-author of the false footnote and should have been an important witness on the Jains' behalf.

## B. The Securities Transactions at Issue in the 16(b) Litigation

### 1. The False Footnote in the InfoSpace IPO Prospectus.

Prior to the IPO, Mr. Jain agreed to place one million of his InfoSpace shares in escrow to secure a personal indemnity obligation. On the eve of the IPO, Wilson and Perkins added a footnote to the 115-page Prospectus stating that Mr. Jain had placed in escrow one million shares owned by one of the trusts. No such event occurred. Mr. Jain was not aware of the footnote when he signed the Prospectus as an InfoSpace Director responsible only for avoiding misstatements material to investors. As Respondents actually contended below, the footnote was false, no such escrow ever was established, and the District Court's ruling to the contrary in the 16(b) action was incorrect.

### 2. The Misdeposits of Trust Shares into the Jains' Personal Account.

After the IPO, InfoSpace stock split. Both the Jains and each of their children's trusts received additional shares. InfoSpace sent all of the share certificates to the Jains; the trusts' certificates should have been sent to the Trustee. The Jains forwarded all of the certificates to their broker, Morgan, which was also slated to become the trusts' broker. Morgan negligently deposited all of the shares – including the trust shares – into the Jains' personal account. At Morgan's request, Wilson (acting as InfoSpace's counsel) authorized re-registering the trust shares to the Jains, falsely

stating in a letter to InfoSpace that the Jains (not the trusts) already owned those shares. Morgan and Wilson did these things because they did not understand that the shares in question belonged to trusts even though the certificates plainly stated that they did.

The Jains were unaware of the misdeposits and false statements. Morgan secretly corrected the misdeposit of shares from one of the trusts without telling anyone of the mistaken deposit. The Jains discovered the other trust misdeposits (long before the 16(b) suit was filed) and immediately had them corrected.

The Jains never had any intention of "purchasing" any shares from the trusts. The trustee never had any intention of selling any trust shares. Any such transaction would have defeated the very estate-planning purposes for which the trusts were created. Because neither the "buyer" nor the "seller" knew that any "transactions" were occurring, there obviously was no agreed "purchase price."

C. The 16(b) Litigation

In 2001, an InfoSpace shareholder, Dreiling, filed suit in federal District Court, alleging that the Jains were liable under 16(b) because the false footnote and misdeposits amounted to "purchases" of InfoSpace stock from the trusts within six months of the Jains' sales of some of their Founders shares. Dreiling argued that 16(b) required the Jains to disgorge a sum equal to the difference between the "purchase" price (which Dreiling claimed was zero

since no price had been agreed upon) and the actual proceeds from the Jains' sale of Founders' shares—*i.e.*, 100% of the proceeds of those sales.

Perkins defended the Jains in the 16(b) Suit without seeking the Jains' waiver of its numerous conflicts of interest: Perkins was representing InfoSpace, the recipient of any 16(b) recovery, in numerous other matters, and owed it fiduciary duties; it was liable to the Jains for authoring the false footnote; and its lawyers were essential witnesses. Perkins conducted virtually no discovery of how the mistakes had come about, did not withdraw in order to testify about its own error in writing the footnote, and did not argue that issues of fact precluded summary judgment against the Jains.

On May 14, 2003, the District Court granted Dreiling's motion for summary judgment, ruling based mainly on the IPO prospectus footnote that an escrow had been established and holding that the misdeposits also were purchases. (App. F, pp. A-69 A-70). The District Court held that the issue of the Jains' innocence was "largely irrelevant" under 16(b) and that, on summary judgment, no determination could be made of whether they had acted in good faith. (*Id.*, p. A-67). The District Court's ruling was predicated on an application of the rule of "voluntariness"—*i.e.*, that the Jains had had some role in the events in question—that the Court admitted was beyond the margins of the most directly applicable precedent. (*Id.*, p. A-76).

On May 29, 2003, successor counsel, on motions for reconsideration and the determination of damages, presented new evidence that explained the

origins of the false footnote and confirmed that Morgan and Wilson had acted based on a mistaken belief that the shares belonging to the trusts were actually owned by the Jains—and had actually misled the Jains as a result of their own mistaken belief. The District Court struck some of this evidence as untimely, denied the motion for reconsideration and held that the Jains were liable for one hundred percent of the proceeds of their Founders' share sales because the trust share "purchases" had been for zero. (App. E, p. A-51).

Judgment was entered against the Jains in the sum of approximately $247 million, including prejudgment interest (*id.*, p. A-60) – by far the largest 16(b) judgment in history. In awarding prejudgment interest, the District Court held that it could not make any determination of whether the Jains were in fact innocent and had acted in good faith. (*id.*, pp. A-55).

On February 23, 2004, the Jains appealed to the Ninth Circuit. To avoid foreclosure on their assets at fire-sale prices, they were forced to liquidate their stock portfolio and buy low-yield bonds as collateral for a $253 million appeal bond. This asset shift led to more than $10 million in demonstrable investment losses—gains that actually would have accrued to their pre-existing portfolio.

On February 15, 2005, the Jains settled by paying InfoSpace $65 million (plus $40 million in insurance).

## II. Proceedings Below

### A. Filing, Removal and Remand

In August, 2003, the Jains commenced this action by filing their original Complaint against Morgan and others (including InfoSpace and its general counsel) in Washington State Superior Court.

The Jains alleged that defendants were responsible, through their errors and omissions, for creating the fictitious escrow "purchase" and for negligently misdepositing trust shares (and in two cases re-registering them); and that the misdeposits, coupled with the false footnote, all of which occurred without the Jains' knowledge (or that of the trustee), were predicates for the Jains' 16(b) liability and resulting damages. The Jains asserted causes of action for breach of fiduciary duty, negligence, unjust enrichment/set-off, and equitable subrogation.

The original defendants removed the case to District Court, where the case was assigned to the same judge who had rendered the 16(b) judgment. Defendants asserted that the District Court had original "federal question" jurisdiction over the Jains' claims because "the established federal policy against allowing indemnification or 'reimbursement' for securities liability bars plaintiffs' claims."

The Jains moved for remand, arguing that "defendants are not parties because of any contribution, indemnity, or 'reimbursement' claim, but because the defendants are directly liable to the

Jains by reason of the defendants' negligence and breaches of fiduciary duties." The Jains further asserted that "[n]o federal law or policy precludes asserting claims under state common law for breaches of fiduciary duties and negligence for damages incurred by a plaintiff in a lawsuit involving Section 16(b) claims."

On January 9, 2004, the District Court remanded the case, stating that:

> [The Jains] are not seeking through this lawsuit to challenge their Section 16(b) liability or to escape enforcement of their Section 16(b) liability.
>
> ...
>
> Instead, the Jains are merely seeking to hold other parties accountable for negligence in causing the damages they incurred as a result of their Section 16(b) liability.

(App. D, A-37). The District Court further recognized that, although the damages recoverable under the Jains' tort claims might be similar to those recoverable under an indemnification claim, the claims were distinct:

> The Jains' claims against these Defendants rests solidly in tort law. Defendants argue that the Jains' claims in this case are indemnity or reimbursement claims in disguise [but] . . . have presented no authority indicating that the elements of negligence and breach of fiduciary duty

> are the same as those for indemnification.

(*Id.*, A-41). Continuing, the District Court stated:

> While the ultimate outcome might be the same if the Jains prevail on their state law claims – i.e. the Jains will recover the amount of damages they incurred as Section 16(b) liability – this does not mean that the Jains' negligence and breach of fiduciary duty state law claims are equivalent to claims for indemnification or reimbursement.

(*Id.*, A-41).

B. Superior Court

Before the action against Morgan and others was remanded, on October 9, 2003 the Jains initiated an action against Perkins in Superior Court. The two actions subsequently were consolidated.

By September 2005, the Jains had settled the underlying 16(b) case and dismissed certain of the original defendants.

On September 19, 2005, the Jains filed their Third Amended Complaint against Morgan and Wilson and their Second Amended Complaint against Perkins. The Jains alleged that Respondents' negligent acts and omissions had caused the 16(b) judgment against them and that

they had acted reasonably in settling, were innocent of any wrongdoing and had been affirmatively misled by the professionals.

The Jains also alleged that their losses could have been avoided had Perkins not had unwaivable conflicts of interest that motivated them to avoid discovery, to refrain from advancing key arguments regarding the origins of the "purchases," to avoid withdrawing and testifying that the footnote was false and even to shrink from arguing that issues of fact precluded summary judgment against their clients.

Asserting claims for negligence, breach of fiduciary duties, equitable apportionment, unjust enrichment, recovery of non-settlement damages, and equitable indemnity, the Jains sought, among other things, a declaration that Respondents were obligated to compensate the Jains for:

> defendants' fault-based shares, based on their respective proportionate fault, of the Jains' direct damages resulting from the judgment and settlement in the 16(b) Suit, including, but not limited to, the costs and other consideration paid or granted by the Jains or on their behalf in settlement of the 16(b) Suit;
>
> ...[and for] the Jains' direct, indirect, consequential and special non-settlement damages resulting from the 16(b) Suit....

On October 25, 2005, Respondents filed motions to dismiss the Jains' Complaints for failure to state a claim, arguing that all of the Jains' claims were barred under a federal policy prohibiting "securities wrongdoers" from seeking indemnification.

On May 4, 2006, the Superior Court granted Respondents' motions, dismissing with prejudice the Jains' Third Amended Complaint against Morgan and Wilson and the Jains' Second Amended Complaint against Perkins. (App. C).

C. Court of Appeals

On October 20, 2006, the Jains appealed the orders of dismissal directly to the Supreme Court of the State of Washington, which then transferred the appeal to the Washington State Court of Appeals on March 6, 2007.

On January 14, 2008, the Court of Appeals affirmed dismissal, determining that the Jains' state law claims were barred by a federal policy against "de facto indemnity" for securities liability, specifically 16(b) liability. (App. B). While conceding that securities professionals and defense counsel "should be answerable in state court for harms they have caused their clients," the court found that "to the extent that state claims constitute any form of indemnification, the strict liability provisions of section 16(b) would be fatally undermined were insiders able to pursue those claims[.]" (*Id.*, A-15). Accordingly, the court held that "because they seek recovery of the profits they were required to disgorge to InfoSpace, the Jains'

claims constitute de facto indemnification and present an insuperable bar to relief." (*Id.*, A-16). The court also noted, in connection with its separate ruling denying the Jains' claim for attorneys' fees (on state law grounds) that the Jains "were not blameless in the transactions giving rise to their [16(b)] liability." (*Id.*, A-17). The conduct described to support this statement was the same conduct the District Court had ruled constituted "voluntariness"; *i.e.*, the Jains did such things as sending the stock certificates to their broker, failing to immediately detect the misdeposits, and signing the IPO prospectus. No court has held that the Jains were even negligent.

D. State Supreme Court.

On October 1, 2008, the State Supreme Court denied the Jains' Petition for Review. (App. A).

## REASONS FOR GRANTING THE WRIT

The Circuits that have addressed the extent to which federal law bars state law claims for losses arising from securities liability by classifying such claims as "de facto indemnity" claims have reached widely different conclusions. The question this Petition raises is how to set the boundaries of any such federal policy so that it supports both the specific goals of the federal statute involved and the broader objectives of the federal securities laws.

Some Circuits have applied the anti-indemnity rule in ways that undermine legitimate state remedies, promote no goal of the federal securities law at issue, and immunize securities

professionals from the consequences of their own negligence. This case was decided in reliance on such rulings. Other Circuits recognize, but in varying degrees, the right of the injured party to recover losses in proportion to the fault of the securities professionals even where (unlike this case) the client was also negligent.

This case is an extreme example of the evils of the "de facto indemnity" bar under the facts the Jains allege. However, the Jains' claims were rejected *on a motion to dismiss*. A pure issue of law is presented here, essentially untainted by the factual complexity reflected in the record.

The specific goals of 16(b) were met when the Jains disgorged their "profits" to InfoSpace in settling to avoid appeal risks (largely created by their defense counsel's failures in connection with the summary judgment motion below). Their state law claims seek to do nothing more than allocate these damages (and their separate investment losses) in proportion to the fault of Respondents. It is a verity on this record that the Jains had no knowledge that the "transactions" were even occurring (the escrow did not occur). This is not a case of negligent advice; the Respondents literally created the short-swing trades through their mistakes. Neither the disgorgement policy of 16(b) nor its deterrence goals are implicated here—one cannot be deterred from engaging in transactions of which one is unaware.

A rule that classifies the Jains' claims as "de facto" indemnity claims that are barred by federal law defeats the federal securities law goal that *is*

implicated here: discouraging careless conduct by securities professionals. The claims are not for "indemnity" because the Jains do not seek to shift damages arising from their own fault, but only to recover their losses to the extent they arose from the careless conduct of others.

The goals of encouraging prudence by securities professionals will be served by this Court's defining a rule that bars only claims for true "indemnity" (shifting damage attributable to the indemnitee's fault or wrongdoing) while upholding the states' right to provide remedies that simply allocate losses according to fault. This rule should apply even in favor of parties who, unlike the Jains, were themselves at fault in creating their own liability as long as the result is not to shift any portion of the loss that is properly allocable to the plaintiff.

## I. The Circuits Are Split

Each Circuit examining the issue has determined that there are circumstances in which a party found liable under the federal securities laws may be prohibited from pursuing claims against third parties for their role in causing that liability or associated losses. As stated by one commentator:

> The cases dealing with indemnification questions in the context of federal securities liability ... do not deal with claims for indemnification against securities law liabilities in an entirely consistent fashion; groups of the cases use three somewhat different standards

> to determine whether a defendant is entitled to be indemnified by other defendants. Some cases take – or at least appear to take – the position that a defendant in a securities action may claim indemnity from another defendant whose degree of fault was greater. Other cases bar indemnification for defendants whose liability is premised on intentional, knowing or reckless behavior, independent of the quality of the behavior of the other defendants in the action, on the rationale that to permit indemnification of such defendants would undercut the deterrent mission of the federal securities laws. On essentially the same rationale, other cases at least suggest that indemnification should be denied to defendants whose liability is based on negligent violations. Some courts have held that indemnification is contrary to public policy for section 16(b) cases, even though the liability arising under section 16(b) for short-swing trading by insiders is the consequence of a strict liability scheme created by statute that does not require any proof of fraudulent intention or negligence.

Deborah A. DeMott, *Shareholder Deriv. Actions L. & Practice*, § 6:43 (2008) (citations omitted[1]).

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[1] Citing, in connection with the discussion of 16(b), *First Golden Bancorporation v. Weiszmann*, 942 F.2d 726 (10th Cir. 1991).

The Second Circuit, in a securities fraud case under § 10(b) of the 1934 Act (15 U.S.C. § 78j(b)), involving an issuer who omitted material facts from an offering circular, prohibited the underwriter from enforcing an indemnification agreement with the issuer where the underwriter was reckless. *Globus v. Law Research Service, Inc.*, 418 F.2d 1276 (2d Cir. 1969). The court found that, where the underwriter had actual knowledge of the misstatement and exhibited "wanton indifference ... to its obligations, 'it would be against public policy embodied in the federal legislation to permit [the underwriter] to enforce its indemnification agreement.'" *Id.*, at 1288. The court added that it was considering only the case were the putative indemnitee "has committed a sin graver than ordinary negligence." *Id.* Taking its cue from the Second Circuit's decision in *Globus*, the District Court for the Southern District of New York has issued a series of cases allowing claims of indemnification by innocent, or merely negligent, defendants accused of violating the federal securities laws.[2] The Jains' claims should have been upheld under this approach.

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discussed *infra*, and the present case.

[2] Citing *Globus* and *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 378 F.Supp. 112 (S.D.N.Y. 1976), the court in *Cambridge Fund, Inc. v. Abella*, 501 F.Supp. 598, 618 (S.D.N.Y. 1980) explained that, "these decisions stand for the proposition that it is against public policy to allow a party who has been adjudicated to have been engaged in reckless, willful or criminal conduct to shift his liability to others." In *Cambridge Fund*, the public policy did not bar indemnification because there had been "no adjudication of willfulness." *Id.*, at 619. The same court later explained that:

> [T]he crucial relevant fact in determining whether indemnification for violations of the

In contrast, the Fourth Circuit has not limited the bar to cases of the claimant's intentional wrongdoing. It has held that the federal securities laws "preempt plaintiff's pendent state claims to the extent they allow a right of action for

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> securities laws is available is whether the defendant acted with actual knowledge of falsity or reckless disregard for the truth. . . . [W]hether indemnification is available may depend on various questions of fact such as whether a party is personally at fault, actually contributed to an injury, incurred merely vicarious or imputed liability, or had actual knowledge of alleged misstatements.

*Arden Way Assoc. v. Boesky*, 664 F. Supp. 863, 865 (S.D.N.Y. 1987). In *Greenwald v. American Medcare Corp.*, 666 F.Supp. 489 (S.D.N.Y. 1987), where defendants accused of securities fraud settled prior to trial, one defendant asserting complete innocence was permitted to pursue his indemnification claim against co-defendants. *Id.*, at 493 ("Spanakos is entitled to an opportunity to prove that he was without fault and is therefore entitled to indemnity."). Explaining the rationale behind *Globus* and its progeny, the court in *Fromer v. Yogel*, 50 F.Supp.2d 227 (S.D.N.Y. 1999) stated that indemnification:

> is not available in a case where the party seeking indemnification has knowingly and willfully violated the federal securities laws. Such a remedy would allow a tortfeasor to shift liability for intentional misconduct onto another joint tortfeasor and thereby undercut the deterrence goals of the securities laws.
>
> ...
>
> [However,] indemnity claims under the Exchange Act may proceed where the wrong committed by those seeking indemnity is no greater than ordinary negligence.

*Id.*, at 237-38 (citations, footnote omitted) (emphasis added).

indemnification." *Baker, Watts & Co. v. Miles & Stockbridge*, 876 F.2d 1101, 1102 (4th Cir. 1989). In *Baker, Watts*, investors successfully sued Baker, Watts under § 12(2) of the 1933 Act for material omissions in an offering memorandum. The corporation then asserted claims for contribution and indemnification against the law firm that drafted the offering memorandum. *Id.*, at 1103. Noting that liability under § 12(2) does not require scienter but may be "predicated upon negligent misrepresentations," the court refused to pre-empt the state law *contribution* claims, based on the law firm's "independent obligation to provide competent legal representation." *Id.*, at 1108. However, the court held that federal policy bars any state-based *indemnification* claims:

> [T]he underlying purpose of the 1933 Act is regulatory rather than compensatory. Negligence in the preparation of a securities prospectus was made actionable under § 12(2) of the 1933 Act in order to promote careful adherence to the requirements of the statute. . . . [A] right of action for indemnification would frustrate the statute's goal of encouraging diligence and discouraging negligence in securities transactions.

*Id.*, at 1105 (quotations, citations omitted). Although the court determined that the federal policy against indemnification is not limited to circumstances where the underlying liability was based on intentional wrongdoing, it stopped short of

establishing a bright line rule barring all claims for indemnification:

> Although a right to indemnification may not be preempted in each and every circumstance, we reject plaintiff's assertion that the federal policy against indemnification extends only to intentional wrongdoing.

*Id.*, at 1108.

The Seventh Circuit, having initially adopted a broad rule barring indemnification claims by "securities wrongdoers," now allows such claims to the extent that they have an independent legal basis in state or federal law. In *Heizer Corp. v. Ross*, 601 F.2d 330, 334 (7th Cir. 1979), the court barred a cross-claim for indemnification of liability imposed for securities fraud, stating that "indemnification tends to frustrate" the policy of securities legislation and that a "securities wrongdoer should not be permitted to escape loss by shifting his entire responsibility to another party." The court later disavowed *Heizer's* policy-based approach. *King v. Gibbs*, 876 F.2d 1275, 1283 (7th Cir. 1989) ("policy analysis has no role to play in the question of whether there is a federal right to indemnification") (*citing Texas Indus., Inc. v. Radcliff Materials, Inc.*, 451 U.S. 630, 638, 101 S.Ct. 2061 (1981)). In *King*, defendant Gibbs faced claims under § 10(b) and SEC Rule 10b-5. He claimed that, as an "innocent conduit of false information" transmitted by cross-claim defendants, the rule of *Heizer* (barring indemnification claims by "securities *wrongdoers*") was inapplicable. *Id.*, at 1276. Apparently in

agreement, the court focused on whether Gibbs could establish a legal basis for his indemnity claims. Gibbs could not rely on state law only because he had failed to preserve the argument. *Id.*, at 1279, n.5. Thus, he was required to show "a right to indemnification under federal law." *Id.*, at 1279. Engaging in an extensive analysis of legislative history and federal common law principles, the court held that, regardless of the level of the claimant's culpability, "there is no right to indemnification under the securities laws or federal common law." *Id.*, at 1276.

Before *King* called *Heizer* into question, the Ninth Circuit invoked *Heizer's* policy arguments to bar a "cross claim for indemnity." *Laventhol, Krekstein, Horwath & Horwath v. Horwitch,* 637 F.2d 672, 676 (9th Cir. 1980). *Laventhol* involved claims for securities fraud under § 11 of the 1933 Act, 15 U.S.C. § 77k. The issue was whether certain non-settling defendants could pursue indemnification or contribution against defendants who had settled for a nominal amount in exchange for their agreement to cooperate with plaintiffs. After noting that contribution was permitted by statute, the court held that the cross-claim for indemnity had been properly dismissed:

> In extending liability to underwriters and those who prepared misleading statements, the purpose of the Act is regulatory rather than compensatory, and permitting indemnity would undermine the statutory purpose of assuring diligent performance of duty and deterring negligence.

*Id.*, at 676. However, the District Court for the Northern District of California has determined that federal law does not bar a corporation's voluntary indemnification of its directors and officers for payments made to settle a securities fraud class action under SEC Rule 10(b)-5, where such indemnification is permitted by state law. *Raychem Corp. v. Fed. Ins. Co.*, 853 F. Supp. 1170, 1177-78 (N.D. Cal. 1994).

The Tenth Circuit is the only Court of Appeals that has addressed the indemnification issue in the context of liability imposed by 16(b). In *First Golden Bancorporation v. Weiszmann,* 942 F.2d 726 (10th Cir. 1991), defendant Weiszmann acquired First Golden stock as a result of a tender offer, which he then sold within six months. First Golden sued Weiszmann under the strict liability provisions of 16(b), which require disgorgement to the issuer of all profits resulting from a statutory insider's[3] sale and purchase, or purchase and sale, of stock within a given six-month period. Weiszmann filed a third-party complaint against his financial advisor, seeking (among other things) "indemnification for any liability he may have to First Golden." *Id.*, at 728. Weiszmann and First Golden settled the primary 16(b) lawsuit on terms that did not require Weiszmann to make any payment to First Golden, though he was required to dismiss certain unspecified counterclaims. *Id.* The court noted that other federal courts have "rejected indemnity for a variety of securities violations" as a matter of policy,

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[3] Although the basis for concluding that Weiszmann was an "insider" subject to 16(b) is not stated, it appears likely that he qualified as a "beneficial owner" with more than 10% of the corporation's stock. 15 U.S.C. § 78p(a), (b).

including that "indemnity would undermine the deterrent purpose of the Acts." *Id.*, at 728-29 (citations omitted). The court found these concerns "applicable to indemnification in section 16(b) cases, even though section 16(b) does not require proof of fraudulent intent" but did not address the differences among the cases it cited, including the Second Circuit's recognition in *Globus*, *supra*, that innocent or merely negligent parties may pursue fault-based claims. *Id.*, at 729. In light of the "clear congressional intent to provide a catch-all, prophylactic remedy, not requiring proof of actual misconduct" the court held that "the public policy behind section 16(b) renders invalid any attempt by an insider to seek indemnification for his liability under section 16(b)." *Id.* (citations omitted).[4]

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[4] Other lower court decisions addressing indemnification for 16(b) liability have taken a more limited approach, concluding that the *issuer* may not indemnify the insider without defeating the 16(b) remedy of disgorgement *to* the issuer. *See, e.g., Bunker Ramo-Eltra Corp. v. Fairchild Industries, Inc.* 639 F. Supp. 409, 419 (D. Md. 1986); *Schaffer v. CC Invs., LDC*, 286 F. Supp. 2d 279, 283 n.6 (D.N.Y., 2003); *In re XO Communications, Inc.*, 330 B.R. 394, 441 (S.D.N.Y. 2005) ("The court is persuaded that allowing indemnification for [Section] 16(b) violations [by the issuing corporation] would frustrate the public policy behind the statute because liable parties would not have to return their short-swing profits to the plaintiff issuer.") (quoting from *Schaffer* but adding the bracketed language). *Bunker-Ramo* explained this rationale, in the context of contractual indemnification by the issuer:

> If this indemnification is found to be valid, then the defendants would have been able to waive, in effect, the requirement of section 16(b) since they would not have to *return* the short-swing profits *back to the plaintiff issuer*.

In affirming the Superior Court's dismissal of the Jains' claims for failure to state a claim, the Court of Appeals relied heavily on *First Golden.* (App. B).

The Third and Eleventh Circuits have considered the issue only in the context of the lower courts' issuance of a "settlement bar order" barring cross-claims for contribution and indemnification between settling and non-settling defendants accused of federal securities law violations.

The Eleventh Circuit bars settling defendants from seeking contribution, indemnity or asserting "interrelated" state law claims against a non-settling defendant. *In re U.S. Oil & Gas Litigation,* 967 F.2d 489 (11th Cir. 1992). In a securities fraud class action involving the sale of investor advisory services related to the purchase of federal oil and gas leases, defendant Pinnacle settled with the plaintiff class before trial, but wished to preserve its cross-claims against a non-settling co-defendant, A&A. *Id.*, at 492. Pinnacle asserted claims for indemnity, fraud, breach of fiduciary duty, and negligence, alleging that A&A wrongfully withheld information of the fraudulent activities. *Id.* The court issued a settlement bar order prohibiting Pinnacle from pursuing its cross-claims, primarily based on policy considerations favoring settlement of complex class action cases. *Id.*, at 493. The court found that independent state law claims, including fraud and negligence, that are "interrelated" with the

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*Id.*, at 419 (emphasis added). Such a result would be a direct violation of Section 29(a) of the Securities Exchange Act – the "anti-waiver provision" – because the issuer would not recover the short-swing profits, as required by 16(b). *Id.*, at 418-19.

indemnification claim and founded on the same facts may be the subject of a proper settlement bar:

> The propriety of the settlement bar order should turn upon the interrelatedness of the claims that it precludes, not upon the labels which parties attach to those claims. If the cross-claims that the district court seeks to extinguish through the entry of a bar order arise out of the same facts as those underlying the litigation, then the district court may exercise its discretion to bar such claims in reaching a fair and equitable settlement.

*Id.* at 496. The court did not rule on whether a settlement bar order could bar "truly independent" claims. *Id.*, at 496, n.5; *see also AAL High Yield Bond Fund v. Deloitte & Touche, LLP*, 361 F.3d 1305, 1312 (11th Cir. 2004) ("the [*U.S. Oil & Gas*] opinion expressly declined to address the issue of 'truly independent claim'"). In *dictum*, the court also noted that "the substantive weakness of Pinnacle's indemnity claim supported the entry of the settlement bar against it" and that "[i]ndemnification claims are not cognizable under the Securities Acts of 1933 and 1934." *In re U.S. Oil & Gas*, 964 F.2d at 495 (citation omitted).

In the Third Circuit, while claims for true indemnification are not permitted as a matter of federal policy, a party liable under the securities laws may recover its losses from a party who has breached independent state law duties to the

claimant. In a securities fraud case involving the sale of securities at artificially inflated prices, plaintiffs settled with certain defendants and the trial court entered an order barring "all claims for contribution or indemnification however denominated" by non-settling defendants (including the underwriter) against settling defendants. *Eichenholtz v. Brennan*, 52 F.3d 478, 481 (3rd Cir. 1995). Affirming issuance of the "settlement bar" order, the court stated that claims for indemnification "run counter to the policies underlying the securities acts":

> The underlying goal of securities legislation is encouraging diligence and discouraging negligence in securities transactions. These goals are accomplished "by exposing issuers and underwriters to the substantial hazard of liability for compensatory damages."

*Id.*, at 484 (citations omitted). The court agreed with other courts that have held the policy against indemnification applies even where the liability imposed by the securities laws is predicated on mere negligence. *Id.*, at 484-85. The court also upheld the bar order as to any contribution claims, because any subsequent judgment against the non-settling defendants would be reduced in proportion to the settling defendants' relative culpability: "The proportionate fault rule is the equivalent of a contribution claim; the non-settling defendants are only responsible for their portion of the liability." *Id.*, at 487. However, because the bar order barred only claims against *settling* defendants, the non-settling underwriter could seek indemnification from

its *non-settling* co-defendant agent "if it is held vicariously liable for [its agent's] conduct." *Id.*, at 485, n.13. The lower courts in the Third Circuit similarly have distinguished between barred indemnification claims and state law claims for breaches of independent duties.[5]

The First, Fifth, and Eighth Circuits each have acknowledged, in *dicta*, the other Circuits' treatment of the issue. *See Happ v. Corning, Inc.*, 466 F.3d 41, 44 (1st Cir. 2006) (recognizing view in "some circuits" that "federal law—although only by implication—forbids indemnification for federal regulatory violations like insider trading") (citing *First Golden*, *Globus*, and *Raychem, supra*); *Stowell v. Ted S. Finkel Investment Services*, 641 F.2d 323, 325 (5th Cir. 1981) ("indemnification tends to frustrate the policy of securities legislation.") (citing *Heizer, supra*); *Professional Beauty Supply, Inc. v. National Beauty Supply, Inc.*, 594 F.2d 1179, 1186 (8th Cir. 1979) (noting, in antitrust case, that "the sound reasoning of the security cases which deny indemnity to tortfeasors who have committed a

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[5] *See, e.g., In re Cendant Corp. Sec. Litig.*, 139 F. Supp. 2d 585, 595 (D.N.J. 2001):

> merely because Cendant's tort and contract claims seek to recover damages that could be recoverable in a state law indemnity action do[es] not convert these claims into impermissible indemnity claims under the federal securities laws. Rather, they are independent, non-indemnity claims that are neither barred nor preempted by the federal securities laws.

*See also In re Sunrise Sec. Litig.*, 793 F.Supp. 1306, 1321 (E.D.Pa. 1992) (same).

wrong graver than ordinary negligence is equally applicable here.") (citations omitted).

## II. This Court's 16(b) Decisions

This Court has never addressed whether, or to what extent, a statutory insider held strictly liable under the provisions of 16(b) may attempt to hold third parties accountable for their role in causing that liability. This Court has not addressed the scope of a defendant's liability under 16(b) since issuing a set of three decisions in the 1970s. In each case, the Court ameliorated the harsh effect of the strict liability provisions of the statute, by narrowing the circumstances under which liability
would be found.

### A. *Reliance Electric Co. v. Emerson Electric Co.*, 404 U.S. 418, 92 S.Ct. 596, 30 L.Ed.2d 575 (1972)

In *Reliance*, this Court was asked to determine whether the owner of more than 10% of a corporation's shares could retain some of its "short-swing" profits by selling the entirety of its holdings in two steps – the first designed to reduce its holdings just below the 10% threshold. Section 16(b) requires that all "short-swing" profits be disgorged where the owner held more than 10% "both at the time of the purchase and sale." This Court held that any profits from the second sale were not recoverable by the corporation even though the transactions expressly were designed to "avoid" 16(b) liability.

Emerson Electric Co. acquired 13.2% of the stock of Dodge Manufacturing Co. pursuant to a tender offer made in an unsuccessful takeover attempt. Shortly thereafter, Dodge shareholders approved a merger with Reliance Electric Co. Emerson thereupon embarked upon a two-step plan to sell its holdings, designed to avoid the full impact of 16(b). First, Emerson sold 37,000 shares to a holding company, reducing its stake in Dodge to 9.96%. Then, two weeks later, it sold the remainder to Dodge.

Reliance demanded the profits from both sales, and Emerson filed a lawsuit seeking a declaration of non-liability. This Court accepted certiorari to the Court of Appeals for the Eighth Circuit.

Discussing the history and purpose of 16(b), this Court recognized that Congress had adopted a "flat rule" of strict liability designed to remove any profits from "a class of transactions in which the possibility of abuse was believed to be intolerably great." *Id.*, at 422. The rule would be applied mechanically and have "sweeping coverage" so as to "insure the optimum prophylactic effect":

> In order to achieve its goals, Congress chose a relatively arbitrary rule capable of easy administration. The objective standard of Section 16(b) imposes strict liability upon substantially all transactions occurring within the statutory time period, regardless of the intent of the insider or the existence of actual speculation. This approach

> maximized the ability of the rule to eradicate speculative abuses by reducing difficulties in proof. Such arbitrary and sweeping coverage was deemed necessary to insure the optimum prophylactic effect.

*Id.* (quoting *Bershad v. McDonough*, 428 F.2d 693, 696 (7th Cir. 1970)).

Reliance argued that Emerson's two sales should be treated as part of a single transaction and that Emerson should be treated as having been a 10% owner "at the time of the [second] sale." The Court rejected the argument:

> To be sure, where alternative constructions of the terms of 16(b) are possible, those terms are to be given the construction that best serves the congressional purpose of curbing short-swing speculation by corporate insiders. But a construction of the term "at the time of ... sale" that treats two sales as one upon proof of a pre-existing intent by the seller is scarcely in harmony with the congressional design of predicating liability upon an "objective measure of proof."

*Id.*, at 424-25 (citation omitted). Accordingly, the Court found that Emerson was not required to disgorge any profits from the second transaction because it technically was not a 10% owner at the time. *Id.*, at 424-25.

B. *Kern County Land Co. v. Occidental Petroleum Co.*, 411 U.S. 582, 93 S.Ct. 1736, 36 L.Ed. 503 (1973)

One year later, in *Kern County*, the Court again limited the reach of 16(b), this time by narrowly construing the term "sale" as not to include certain "unorthodox" transactions where there is no opportunity for "speculative abuse" based on inside information.

As in *Reliance*, *Kern County* involved a failed takeover attempt. Defendant Occidental became a "beneficial owner" subject to 16(b) when it acquired more than 10% of Kern's stock in a tender offer. Soon thereafter, Kern and Tennecco signed a merger agreement that, upon approval by Kern's shareholders, would entitle Occidental to exchange each share of Kern stock for one share of Tennecco stock. So as not to become a minority shareholder of Tennecco, Occidental and Tennecco entered into a call option contract whereby Tennecco acquired the right to purchase Occidental's Tennecco stock outside the six-month short-swing period. Subsequently, Occidental exchanged its Kern shares and Tennecco exercised its option, resulting in total profits to Occidental of almost $20 million.

Citing its introductory clause, the Court noted that 16(b) was enacted "for the purpose of preventing the unfair use of information which may have been obtained by (a statutory insider) ... by reason of his relationship to the issuer." *Id.*, at 591. Citing the statute's legislative history, the Court also noted that "the bill aimed at protecting the public 'by preventing directors, officers, and principal

stockholders of a corporation ... from speculating in the stock on the basis of information not available to others" (*id.*, at 592) and reflects "a congressional effort to curb short-swing trading by insiders whose position gives them access to information not available to the investing public and the ability to influence corporate policy." *Id.*, at 592, n. 23.

Although the Court noted that many decisions have been read to apply an "objective" test under 16(b), "[b]y far the greater weight of authority is to the effect that a "pragmatic" approach to 16(b) will best serve the statutory goals." *Id.*, at 594, n.26.

The Court recognized that Occidental "knew it could sell its stock to the target company's merger partner at a substantial profit" if its own takeover attempt was unsuccessful. *Id.*, at 597. But this was not the type of speculation 16(b) was designed to prevent. Ultimately, the Court found that any "sales" by Occidental were essentially "involuntary" and, due to the hostile nature of the takeover bid, not based on inside information:

> [T]he involuntary nature of Occidental's exchange, when coupled with the absence of the possibility of speculative abuse of inside information, convinces us that 16(b) should not apply to transactions such as this one.

*Id.*, at 600. Similarly, because the "call" option contract afforded the buyer – Tennecco – the right, in its discretion, to purchase the Kern shares, there was no possibility of "speculative abuse" because

Occidental would not benefit from a rising market. *Id.*, at 602.

C. *Foremost-McKeeson, Inc. v. Provident Securities Co.*, 423 U.S. 232, 96 S.Ct. 508, 46 L.Ed.2d 464 (1976).

In *Foremost*, the Court continued to narrow the circumstances in which a statutory insider may be found liable under 16(b). As in *Reliance Electric*, where the Court found a "beneficial owner" must own more than 10% immediately prior to any *sale* subject to 16(b), in *Foremost*, the Court created symmetry by holding that the owner must have owned more than 10% immediately prior to any *purchase* subject to 16(b).

Provident Securities Co. sold its assets to Foremost in exchange for cash and debentures immediately convertible into more than 10% of Foremost stock. *Id.*, at 236. The next day, the parties entered into an underwriting agreement with a third party, pursuant to which Provident sold a substantial amount of the debentures to an underwriter for slightly more than face value. Provident then sued for a declaration that it was not liable to Foremost for any profits on the sale of the debentures.

Provident argued that it fell within the "exemptive provision" of 16(b) –exempting transactions "where such beneficial owner was not such both at the time of the purchase and sale" – because it was not a 10% owner of Foremost stock at the time it initially acquired the debentures. *Id.*, 239. The Court of Appeals agreed: "Congress

intended to reach only those beneficial owners who both bought and sold on the basis of inside information, which was available to them only after they became statutory 'insiders.'" *Id.*, at 242-43.

While Foremost acknowledged the ambiguity of the "exemptive provision," it argued that "where 'alternative constructions' of 16(b)'s terms are available, [courts] should choose the construction that best serves the statute's purposes" relying on *Reliance Electric* and *Kern County*. However, the Court rejected the argument:

> In neither of those cases, however, did the Court adopt the construction that would have imposed liability, thus recognizing that serving the congressional purpose does not require resolving every ambiguity in favor of liability under 16(b).

*Id.*, at 252.

## III. Claims to Apportion Damages for Violations of the Federal Securities Laws Based on FaultShould Be Treated Uniformly

While this Court never has had occasion to address whether state law claims may be barred as "indemnity" or "de facto" indemnity claims for securities law liability, it came closest to doing so in *Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286, 113 S. Ct. 2085, 124 L. Ed. 2d 194 (1993). There, the Court concluded that there was an implied right of contribution under § 10(b) of the 1934 Act and SEC Rule 10b-5. In reaching its

decision, the Court determined that, even where the claimant was adjudged liable for intentional wrongdoing, the right to contribution was not at odds with any policy underlying or expressed in the 1934 Act. *Id.*, at 298.

Two years later, Congress passed the Private Securities Litigation Reform Act of 1995 ("PSLRA"), codifying an express right to contribution. 15 U.S.C. § 78u-4(f)(8). The legislative history of the PSLRA explains the rationale behind contribution in cases involving the federal securities laws:

> One of the most manifestly unfair aspects of the current system of securities litigation is its imposition of liability on one party for injury actually caused by another. . . .
>
> The current system of joint and several liability creates coercive pressure for entirely innocent parties to settle meritless claims rather than risk exposing themselves to liability for a grossly disproportionate share of the damages in the case.

H.R. Conf. Rep. No. 104-369 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 736-37.

The Jains cannot claim contribution in this action because 16(b) liability extends only to the insider whose purchases and sales occur within six months of each other. "Contribution" arises only where there is joint liability. Parties who caused short-swing transactions, for which the Jains were

held strictly liable, are not liable to the issuer under 16(b). The relief sought by the Jains in this action, however, is conceptually and substantively similar to the contribution rights recognized by this Court in *Musick, Peeler* and determined by this Court to be consistent with the policy underlying the 1934 Act. It also is consistent with the policies embodied in the PSLRA.

Fault-based claims for damages arising from 16(b) liability should not be barred under federal law unless doing so would defeat 16(b)'s deterrent policies, including its prescription of a "flat rule" designed for "mechanical application." Liability under 16(b) does not imply wrongdoing or even fault—it is "strict." The purpose of the statute is to make short-swing trades pointless—*i.e.*, by assuring that the insider must disgorge any profit to the issuing corporation. For this reason, contractual indemnity *by the issuer* has been properly held to be inconsistent with federal law (and 16(b)).[6] Such indemnity would defeat the disgorgement policy that is central to deterrence.

Where the insider has paid the issuer but seeks to recover all or part of the loss because the trades arose from the negligence of securities professionals, allowing recovery is not inconsistent with 16(b)'s policies. First, the statute's mechanical application has produced the intended result: the insider has paid any profit over to the issuer. Second, the deterrent effect of 16(b) has been achieved: the insider retains no profits, but only the right to establish that others were at fault in

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[6] *See* n.4, *supra*.

creating the conditions that gave rise to liability. As in the case of classic "contribution," one cannot be "deterred" from being the victim of others' mistakes.

This case starkly presents the central question on which the Circuits differ: Can securities professionals escape responsibility for negligence on public policy grounds where the objectives of the securities statute under which their client's loss occurred were satisfied? The Jains have disgorged their "profits" via the settlement. Section 16(b)'s deterrent policy—including its mechanical application approach to liability—has been achieved. No policy of 16(b) outweighs the clear policy of the securities laws to deter negligence, and encourage prudence, by professionals who handle securities transactions for their clients and author the prospectuses on which investments are based. No "anti-indemnity" policy should bar the Jains from allocating their losses to those whose negligence caused them.

By contrast, an "anti-indemnity" policy limited to cases where a securities law violator seeks damages allocable to its own negligence or wrongdoing serves the same federal goal as allowing fault-based claims: encouraging prudence and probity.

The Second, Third and Seventh Circuits appear to have struck the appropriate balance, allowing claims that allocate losses according to fault. The Tenth and Eleventh Circuit do not permit such claims. The result in the remaining Circuits is less clear.

This thicket of contradictory approaches across the Circuits creates many routes for negligent securities professionals to escape responsibility for the damage they have caused. Like the Jains, the clients of such professionals are left in the lurch when no sound reason exists for the federal courts to sponsor such a result.

## CONCLUSION

For the foregoing reasons, Naveen and Anuradha Jain respectfully request that the Court grant their Petition for Writ of Certiorari.

DATED this 30th day of December, 2008.


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APPENDIX A

THE SUPREME COURT OF WASHINGTON

| | | |
|---|---|---|
| NAVEEN JAIN and ANURADHA JAIN, husband and wife, and their Marital community, | ) | NO. 81388-4 |
| | ) | ORDER |
| Petitioners, | ) | C/A NO. 59661-6-I |
| v. | ) | |
| J.P. MORGAN SECURITIES, INC., A Delaware corporation, as successor In interest to Hambrecht & Quist LLC; WILSON SONSINI GOODRICH & ROSATI, P.C., a California professional Corporation; and PERKINS COIE LLP, | ) | |
| Respondents. | ) | |
| NAVEEN JAIN and ANURADHA JAIN, | ) | |
| Petitioners | ) | |
| v. | ) | |
| PERKINS COIE, LLP, | ) | |
| Respondents. | ) | |

Department I of the Court, composed of Chief Justice Alexander and Justices C. Johnson, Sanders, Owens and J. Johnson, at its October 1, 2008, Motion Calendar, considered whether review should be granted pursuant to RAP 13.4(b), and unanimously agreed that the following order be entered.

IT IS ORDERED:

That the Petition for Review is denied. The Respondents' joint motion to strike the reply to answer is granted.

DATED at Olympia, Washington this 1st day of October, 2008.

For the Court

/s/ Gerry L. Alexander
CHIEF JUSTICE

APPENDIX B

Court of Appeals of Washington, Division 1.
Naveen JAIN and Anuradha Jain, husband and wife, and their marital community, Appellants/Cross-Respondents,
v.
J.P. MORGAN SECURITIES, INC., a Delaware corporation, as successor in interest to Hambrecht & Quist LLC; Wilson Sonsini Goodrich & Rosati, P.C., a California professional corporation, Respondents,
Perkins Coie LLP, Respondent/Cross-Appellant.
No. 59661-6-I.

Jan. 14, 2008.
Reconsideration Denied Feb. 12, 2008.

Background: After settling shareholder suit for alleged "short-swing" trading, former corporate director brought action against brokerage and law firms for negligence, breach of fiduciary duty, legal malpractice, and equitable indemnity. Defendants removed to federal court. The United States District Court for the Western District of Washington, 2004 WL 212999,Pechman, J., remanded. The Superior Court, King County, Richard A Jones, J., dismissed. Director appealed.

Holdings: The Court of Appeals, Baker, J., held that:
(1) claims were de facto indemnity claims barred under federal securities law, and
(2) director did not qualify under "ABC rule" to recover attorney fees.

Affirmed.

Appelwick, C.J., filed concurring opinion.

**118 Arthur Washington Harrigan Jr., Timothy George Leyh, Katherine See Kennedy, Randall Thor Thomsen, Danielson Harrigan Leyh & Tollefson LLP, Larry Steven Gangnes, John R. Neeleman, Theodore Alexander Sheffield, Lane Powell PC, Robert B. Gould, Attorney at Law, Seattle, WA, for Appellants/Cross-Respondents.
Brian Corker Free, Michael Ramsey Scott, Hillis Clark Martin & Peterson, PS, John D. Pernick, David M. Balabanian, Bingham McCutcheon LLP, San Francisco, CA, Gregory J. Hollon, Barbara Himes Schuknecht, Robert M. Sulkin, McNaul Ebel Nawrot & Helgren, Seattle, WA, for Respondents.
Bradley S. Keller, Keith David Petrak, Attorney at Law, Howard Mark Goodfriend, Edwards Sieh Smith & Goodfriend PS, Seattle, WA, for Respondent/Cross-Appellant.

BAKER, J.
*577 ¶ 1 The Jains were found by a federal district court to have violated section 16(b) of the Securities Exchange Act of 1934.[1] The case was settled pending appeal. The Jains then brought state tort claims against a brokerage**119 and two law firms involved in the securities case. The superior court dismissed those claims, finding that they constituted de facto indemnity claims barred under federal securities law. We affirm.

¶ 2 Naveen Jain founded InfoSpace, Inc. in 1996, and served as an officer and director of the company until 2002. In 1998, InfoSpace went public, and sold

[1] Codified at 15 U.S.C.A. § 78p.(b).

five million shares of common stock. The lead underwriter of the initial public offering (IPO) was Hambrecht and Quist (subsequently acquired by respondent J.P. Morgan (Morgan)). InfoSpace was represented by respondent Perkins Coie LLP (Perkins). Respondent Wilson Sonsini Goodrich & Rosati, P.C. (Wilson) served as Morgan's counsel.

*578 ¶ 3 For the benefit of their children, Jain and his wife Anuradha established three trusts for which Jain's brother served as trustee. Two of the trusts were initially funded with two million shares of InfoSpace stock, and the third purchased one million shares of InfoSpace stock from the Jains.

¶ 4 As InfoSpace was preparing for its IPO in late 1998, Jain executed an indemnification agreement with InfoSpace, agreeing to place one million shares of InfoSpace stock into an escrow account. Jain signed a registration statement and prospectus sent to the Securities and Exchange Commission (SEC). The prospectus included a footnote disclosing the indemnity agreement, stating that Jain had placed one million shares held by one of the trusts into escrow, and indicating that Jain retained voting control over the shares. According to the Jains, no escrow account was ever actually created. Nevertheless, over the next year, Jain signed, or authorized his attorney to sign, numerous SEC filings representing that he had placed the trust shares in escrow.

¶ 5 In 1999, InfoSpace stock split two-for-one, and Jain, like other shareholders, was issued new share certificates. Two of the trusts were entitled to nearly one million shares, and the third to 500,000 shares. After the Jains mistakenly sent the trust shares to

Morgan, Morgan deposited them into the Jains' personal account. The alleged mis-deposits into the Jains' personal account were subsequently rectified, and the shares transferred to the appropriate trusts. The Jains claim not to have read their brokerage statements, and were thus initially unaware of the mis-deposits.

¶ 6 In 2001, an InfoSpace shareholder, Thomas Dreiling, filed suit in United States District Court, naming the Jains as defendants for engaging in "short-swing" trading in violation of section 16(b) of the Securities Exchange Act of 1934.

¶ 7 Dreiling alleged that the Jains engaged in four purchases that subjected them to liability for short-swing trades. He contended that the escrow set up under the *579 indemnity agreement constituted an unlawful transfer of shares from one of the trusts to Jain, triggering liability for short-swing trades. The other alleged purchases occurred at the time the InfoSpace stock split and shares intended for the trusts were deposited instead in the Jains' personal brokerage account. It was undisputed that the Jains sold InfoSpace shares within six months of the alleged purchases.

¶ 8 The district court ruled that the transferred shares were purchases for purposes of determining whether short-swing trades had occurred, and granted Dreiling summary judgment. The court entered judgment against the Jains, ordering that the putative profits realized from the sales be disgorged to InfoSpace as required under section 16(b). The court also ordered payment of prejudgment interest.

¶ 9 The Jains appealed. Pending the appeal, they obtained a supersedeas bond, and the district court stayed execution of the judgment. The SEC interceded on the Jains' behalf and filed an amicus brief in support of their appeal. Before the appeal was heard, however, the Jains entered into a global settlement with Dreiling, InfoSpace, and various insurers.

¶ 10 The Jains then filed suit against the respondents in superior court, alleging, inter alia, negligence, breach of fiduciary duty, legal malpractice, and equitable indemnity. They sought reimbursement by the respondents**120 for the costs and damages resulting from the judgment and settlement in the 16(b) suit, including attorney fees and litigation costs, as well as the loss of appreciation and other opportunity costs to their investment portfolios alleged to have resulted from obtaining the supersedeas bond. The Jains alleged various irregularities regarding the escrow account, the footnote in the SEC prospectus regarding the escrow account, the mis-deposit of split stock shares into their personal account rather than the trust account, and numerous claims of legal malpractice by Perkins in its representation of the Jains in the federal 16(b) suit.

*580 ¶ 11 The court dismissed the Jains' complaints. The Jains now appeal.

II

[1][2] ¶ 12 A trial court's ruling to dismiss a claim

under CR 12(b)(6) is reviewed de novo.[2] Dismissal is warranted only if the court concludes, beyond a reasonable doubt, the plaintiff cannot prove any set of facts which would justify recovery.[3] The court presumes all facts alleged in the plaintiff's complaint are true.[4] The court is not, however, required to accept the complaint's legal conclusions as true.[5] A motion to dismiss is granted sparingly and with care and, as a practical matter, only where it appears on the face of the complaint that there is some insuperable bar to relief.[6] Here, section 16(b) and the Washington State "ABC rule" governing attorney fees bar the Jains' claims.

*De Facto Indemnification*

¶ 13 Section 16(b) of the Securities Exchange Act is designed to deter transactions which have a high potential for fraud.[7] The section prohibits corporate insiders from buying and selling their company's stock within a six-month period.[8] Profits resulting from purchase-and-sale, or sale-and-repurchase transactions within a period of less than six months are commonly known as "short-swing" transactions.[9]

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[2] *Tenore v. AT & T Wireless Servs.*, 136 Wash.2d 322, 329-30, 962 P.2d 104 (1998).
[3] *Tenore*, 136 Wash.2d at 330, 962 P.2d 104.
[4] *Tenore*, 136 Wash.2d at 330, 962 P.2d 104.
[5] *Haberman v. Wash. Pub. Power Supply Sys.*, 109 Wash.2d 107, 120, 744 P.2d 1032, 750 P.2d 254 (1987).
[6] *Kinney v. Cook*, 159 Wash.2d 837, 842, 154 P.3d 206 (2007) (quoting *Hoffer v. State*, 110 Wash.2d 415, 420, 755 P.2d 781 (1988)).
[7] *First Golden Bancorporation v. Weiszmann*, 942 F.2d 726, 729 (10th Cir.1991).
[8] 15 U.S.C.A. § 78p.(b).
[9] *Roth v. Jennings*, 489 F.3d 499, 507 (2d Cir.2007).

*581 ¶ 14 Congress recognized that insiders may have access to information about their corporations not available to the rest of the investing public.[10] By trading on this information, insiders could reap profits at the expense of less well informed investors.[11] Congress sought to curb insider trading by enacting a strict rule requiring any insider who violates section 16(b) to return to the company any profits they might gain.[12]

¶ 15 Where the possibility of abuse is so intolerably great, Congress deemed such a strict rule to be the only effective method of curbing the evils of insider trading, and considered the rule's arbitrary and sweeping coverage necessary to insure the optimum prophylactic effect.[13]

[3] ¶ 16 Unlike other provisions of the securities laws, section 16(b) is a strict liability provision where questions of intent or scienter are irrelevant.[14] This approach maximizes the ability of the rule to eradicate speculative abuses by reducing difficulties in **121 proof. The thrust of the statutory scheme thus places responsibility for meticulous observance of the provision squarely on the shoulders of the insider alone.[15] The insider is deemed capable of structuring his or her dealings to avoid any possibili-

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[10] *Foremost-McKesson, Inc. v. Provident Sec. Co.*, 423 U.S. 232, 243, 96 S.Ct. 508, 46 L.Ed.2d 464 (1976).
[11] *Foremost-McKesson*, 423 U.S. at 243, 96 S.Ct. 508.
[12] 15 U.S.C.A. § 78p.(b).
[13] *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 422, 92 S.Ct. 596, 30 L.Ed.2d 575 (1972) (quoting *Bershad v. McDonough*, 428 F.2d 693, 696 (7th Cir.1970)).
[14] *Deephaven Capital Mgmt., LLC v. Schnell*, No. 06-844, 2007 WL 38911, 2007 U.S. Dist. LEXIS 1504, at *8 (Jan. 5, 2007)
[15] *Bershad v. McDonough*, 428 F.2d 693, 696 (7th Cir.1970).

ty of taint, and therefore must bear the risks of any inadvertent miscalculation.[16]

¶ 17 Congress recognized from the outset that section 16(b) might impose liability on some innocent insiders whose *582 short-swing transactions were wholly inadvertent.[17] Nevertheless, while the results may be harsh in individual cases, this arbitrary rule is necessary to attain the goal set forth in the statute.[18]

[4] ¶ 18 It is well settled that an insider found to have violated section 16(b) may not seek indemnification for the ensuing liability.[19] This is to prevent an insider from effectively waiving the requirement that short-swing profits be returned, thus frustrating the policy behind section 16(b).[20]

[5] ¶ 19 In addition to barring direct indemnity, the courts also bar de facto indemnification.[21] To the extent that a plaintiff's state actions are found to be de facto claims for indemnification, they are preempted.[22] Claims integrally related to securities

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[16] *Bershad*, 428 F.2d at 696.

[17] Peter J. Romeo & Alan L. Dye, Section 16 Deskbook 365 (2007).

[18] *Petteys v. Butler*, 367 F.2d 528, 532 (8th Cir.1966).

[19] *See First Golden Bancorporation*, 942 F.2d at 728-29; *Bunker Ramo-Eltra Corp. v. Fairchild Indus., Inc.*, 639 F.Supp. 409, 418-19 (D.Md.1986).

[20] *Schaffer ex rel. Lasersight, Inc. v. CC Invs., LDC*, 286 F.Supp.2d 279, 283 (2003); *Bunker Ramo-Eltra Corp.*, 639 F.Supp. at 419.

[21] *Lucas v. Hackett Assocs., Inc.*, 18 F.Supp.2d 531, 536 (E.D.Pa.1998); *Baker, Watts & Co. v. Miles & Stockbridge*, 876 F.2d 1101, 1108 (4th Cir.1989).

[22] *Baker, Watts*, 876 F.2d at 1108.

claims that have been settled are likewise preempted by federal securities laws.[23]

¶ 20 The Jains argue that their state law claims are legally distinguishable, fault-based claims approved by federal securities law, and are not merely de facto indemnity claims. They further argue that barring their state tort claims will serve to shield brokers and law firms from negligence and breach of duty claims.

¶ 21 The respondents insist that section 16(b) serves as a categorical bar on recovery, and that the Jains' state tort actions can be viewed only as de facto indemnity claims.

¶ 22 Those courts which have dealt with indemnification under section 16(b) have reached a harsh and restrictive *583 conclusion. Given that section 16(b) is a strict liability provision, any claim which is colorable as indemnity or de facto indemnity is barred.

¶ 23 For guidance on distinguishing de facto indemnification from separate tort claims, we turn to *First Golden Bancorporation v. Weiszmann.*[24]

¶ 24 First Golden Bancorporation sued Weiszmann for recovery of profits he made through short-swing trades in violation of section 16(b).[25] Weiszmann, in turn, brought third party claims against Morgan Stanley, which had acted as Weiszmann's financial advisor during the course of the section 16(b) viola-

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[23] *In re Cendant Corp. Sec. Litig.*, 139 F.Supp.2d 585, 596 (D.N.J.2001).

[24] 942 F.2d 726 (10th Cir.1991).

[25] *First Golden*, 942 F.2d at 728.

tion, and against the purchaser of the stock.[26] He claimed indemnity, as well as a number of state tort claims including outrageous conduct, breach of contract, fraud, and negligent representation.[27] He sought indemnification for any liability to First Golden, reimbursement of attorney fees and costs, and recovery of commissions and profit realized by Morgan Stanley from the sale of the stock.[28]

**122 ¶ 25 The court upheld the dismissal of Weiszmann's indemnity claim, noting that such indemnity contravened the public policy enunciated by the federal securities laws.[29] While Congress felt that the imposition of strict liability was the most effective way to deter fraud, the imposition of strict liability did not minimize the purpose of preventing fraudulent trading based upon insider information or manipulation.[30]

¶ 26 The court then proceeded to analyze Weiszmann's remaining claims to determine whether they constituted de *584 facto indemnification, stating that to the extent that they were disguised indemnity claims, they could not stand.[31] The court drew a distinction between profits which would rightly be disgorged to First Golden, and those which arose separately.[32] Thus, for instance, Weiszmann might properly seek the return of Morgan's commissions and profits from the sale of First Golden stock.

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[26] *First Golden*, 942 F.2d at 728.
[27] *First Golden*, 942 F.2d at 728.
[28] *First Golden*, 942 F.2d at 728.
[29] *First Golden*, 942 F.2d at 728.
[30] *First Golden*, 942 F.2d at 729.
[31] *First Golden*, 942 F.2d at 731-32.
[32] *First Golden*, 942 F.2d at 731.

We note that the $112,260 sum at issue in these remaining claims is not part of First Golden's claims against Weiszmann because the profit made by the third-party defendants is clearly not profit inuring to Weiszmann through his sale of First Golden stock. Therefore, because First Golden never had a right to this $112,260, Weiszmann may be able to characterize this portion of his third-party claims as non-indemnity claims.[33]

¶ 27 The court held that the profits and commissions the third parties earned off the sale of Weiszmann's stock were clearly not recoverable by First Golden in its original section 16(b) action, and to that extent Weiszmann's claims may not have been de facto indemnity claims.[34]

¶ 28 The court then remanded to the district court to review the claims and determine whether and to what extent they sought relief other than indemnification.[35] The court instructed the district court that to the extent any of the claims were indemnification claims for liability that Weiszmann incurred under section 16(b), they should be dismissed with prejudice.[36]

¶ 29 The *First Golden* court's analysis is reinforced by the recent holding in *585*Deephaven Capital Mgmt., LLC v. Schnell*.[37] Deephaven sued Schnell, one of its portfolio managers, alleging that Schnell's

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[33] *First Golden*, 942 F.2d at 731.
[34] *First Golden*, 942 F.2d at 732.
[35] *First Golden*, 942 F.2d at 732.
[36] *First Golden*, 942 F.2d at 732.
[37] No. 06-844, 2007 WL 38911, 2007 U.S. Dist. LEXIS 1504 (Jan. 5.2007).

trading activities on behalf of funds he managed caused the funds to violate section 16(b).[38] The court held that any indemnity for section 16(b) violations would undermine the deterrent purpose of the section by allowing a wrongdoer to recoup its disgorged profits. It concluded that Deephaven was not entitled to seek reimbursement for short-swing profits it disgorged, even when the losses resulted from allegedly rogue trades by one of its own managers.[39]

¶ 30 The *First Golden* court remarked that strict liability did not minimize the purpose behind the securities statute.[40] If anything, that understates the case. Section 16(b) is draconian. By imposing strict liability, Congress has given notice to insiders that they should exercise great vigilance in the disposition of their shares. The necessity of protecting investors is no less compelling today than it was when Congress wrote the securities act. To allow indemnification or de facto indemnification by an insider would run **123 counter to the public policy behind section 16(b).

¶ 31 The *First Golden* court's analysis of de facto indemnity is persuasive. Under its holding, to whatever extent funds recovered under a state tort claim are comparable to the funds disgorged under section 16(b), they must be barred as de facto indemnification.

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[38] *Deephaven*, 2007 WL 38911, 2007 U.S. Dist. LEXIS 1504, at *1-3.

[39] *Deephaven*, 2007 WL 38911, 2007 U.S. Dist. LEXIS 1504, at *8-10.; Peter J. Romeo & Alan L. Dye, Section 16 Deskbook 371 (2007).

[40] *First Golden*, 942 F.2d at 729.

[6] ¶ 32 The Jains listed equitable indemnity as one of their causes of action. They seek reimbursement by the respondents for the costs and damages resulting from the judgment and settlement in the 16(b) suit, the attorney fees they expended in defending the section 16(b) action, and the investment losses they claim to have suffered in connection *586 with the bonding requirements for their appeal of the section 16(b) action.

¶ 33 The Jains' request for equitable indemnification reinforces the respondents' contention that the Jains' claims are merely requests for de facto indemnification in a different guise.

¶ 34 The Jains argue that dismissal of their state tort claims might shield securities professionals from the consequences of their negligence and malpractice. Certainly the state has a strong interest in enforcing its tort laws. Brokers, financial advisors, and lawyers should be answerable in state court for harms they have caused their clients. But, to the extent that state claims constitute any form of indemnification, the strict liability provisions of section 16(b) would be fatally undermined were insiders able to pursue those claims, however named, against third parties. To permit such claims to proceed would essentially make the insiders whole again, as if they had not been obliged to disgorge their profits in the first place.

¶ 35 The Supreme Court made clear that section 16(b)'s arbitrary and sweeping coverage was deemed necessary to insure the optimum prophylactic ef-

fect.[41] Only by exercising uncompromising rigidity can the courts maintain the prophylactic standard of behavior imposed by section 16(b).[42]

¶ 36 The Jains' argument that the state has an interest in allowing their claims to proceed under separate and distinct legal theories must ultimately give way to the bright line, strict liability provisions of section 16(b). We hold that because they seek recovery of the profits they were required to disgorge to InfoSpace, the Jains' claims constitute de facto indemnification and present an insuperable bar to relief. To the extent the Jains raise other claims, *587 they are governed by state law. Because we hold the Jains' claims are barred, we do not address Perkins's cross-appeal.

*The ABC rule*

[7] ¶ 37 In addition to being barred as de facto indemnity, the Jains' claims also fail to satisfy the requirements of Washington's "ABC rule."

[8] ¶ 38 The general rule in Washington is that attorney fees are not awarded unless permitted by contract, statute, or in specific equitable circumstances.[43] One such equitable exception is the so-called "ABC rule," which allows an award of attorney fees as consequential damages.[44]

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[41] *Reliance*, 404 U.S. at 422, 92 S.Ct. 596 (quoting *Bershad*, 428 F.2d at 696).

[42] *Volk v. Zlotoff*, 285 F.Supp. 650, 656 (D.C.N.Y.1968) (quoting *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545 (1928)).

[43] *Morgan v. Roller*, 58 Wash.App. 728, 730, 794 P.2d 1313 (1990).

[44] *Manning v. Loidhamer*, 13 Wash.App. 766, 769, 538 P.2d

¶ 39 However, we have consistently held that a party may not recover attorney fees or costs of litigation under the theory of equitable indemnity if, in addition to the wrongful act or omission of A, there are other reasons why B became involved in litigation with C.[45] "[T]he critical inquiry under the causation element of equitable indemnity is whether, apart from A's actions, B's own conduct caused it to be 'exposed' or 'involved' in litigation with C."[46]

**124 ¶ 40 The Jains were not blameless in the transactions giving rise to their liability. The district court laid out how the Jains' own actions caused them to run afoul of section 16(b):

> The Jains signed papers allowing transfer of funds from the [trusts]. The Jains caused deposits of trust stock into their personal brokerage accounts by forwarding stock certificates to their personal broker. Mr. Jain promised to place shares of the ... trust into escrow to fulfill a personal obligation. The fact that the Jains failed to read their brokerage statements, simply signed legal documents without knowing what they were, and *588 mistakenly sent certificates to their personal broker does not make their actions involuntary.... [T]he Jains participated in the transfers and retained more than a degree of control over the transactions. Without the participation of the Jains, the transfers would not have happened.

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136, 86 Wash.2d 1001 (1975).

[45] *Tradewell Group, Inc. v. Mavis*, 71 Wash.App. 120, 126, 857 P.2d 1053 (1993).

[46] *Tradewell Group*, 71 Wash.App. at 129, 857 P.2d 1053.

¶ 41 We hold that the Jains' own conduct caused them to be involved in the litigation and, therefore, under the ABC rule they may not recover fees or litigation costs.

¶ 42 The superior court's grant of the respondents' motions to dismiss is affirmed.

¶ 43 AFFIRMED.

I CONCUR: COLEMAN, J. Pro Tem.APPELWICK, C.J. (concurring).

¶ 44 I concur in the reasoning and result reached by the majority. The majority opinion tacitly acknowledges the Jain's claims for attorney fees were not extinguished by section 16(b)

¶ 45 I would however explicitly hold that section 16(b) of the Securities Exchange Act of 1934 [FN1] is not a bar to malpractice claims under state tort law. Rather the act limits the relief available under those claims by precluding indemnification for profits disgorged for violation of the act. The unavailability of indemnity will be dispositive of claims in some cases, but not necessarily all.

FN1. Codified at 15 U.S.C.A. § 78p.(b).

Wash.App. Div. 1,2008.
Jain v. J.P. Morgan Securities, Inc.
142 Wash.App. 574, 177 P.3d 117

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APPENDIX C

HONORABLE RICHARD JONES

IN THE SUPERIOR COURT OF WASHINGTON
FOR KING COUNTY

| | |
|---|---|
| NAVEEN JAIN and ANURADHA JAIN,<br><br>Plaintiffs,<br><br>vs.<br><br>J.P. MORGAN SECURITIES, INC., a Delaware corporation, as successor in interest to Hambrecht & Quist LLC; and WILSON SONSINI GOODRICH & ROSATI, a California professional corporation,<br><br>Defendants. | CONSOLIDATED<br><br>NO. 03-2-32427-2 SEA<br><br>[Consolidated with 03-2-34789-2 SEA and 04-2-1655-0 SEA]<br><br>ORDER GRANTING DEFENDANT J.P. MORGAN SECURITIES, INC.'S MOTION TO DISMISS |
| NAVEEN JAIN and ANURADHA JAIN,<br><br>Plaintiffs,<br><br>vs.<br><br>PERKINS COIE LLP,<br><br>Defendant. | |

Before this Court is Defendant J.P. Morgan Securities, Inc.'s Motion to Dismiss. In connection with this motion, the Court has reviewed the following materials:

1. Defendant J.P. Morgan Securities, Inc.'s Motion to Dismiss;

2. Defendant J.P. Morgan Securities, Inc.'s Request for Judicial Notice in Support of Defendant J.P. Morgan Securities, Inc.'s Motion to Dismiss;

3. Consolidated Opposition of Naveen and Anuradha Jain to Motions to Dismiss by Wilson Sonsini Goodrich and Rosati, P.C. and J.P. Morgan Securities, Inc.;

4. The Declaration of Timothy Leyh In Support of the Consolidated Opposition of Naveen and Anuradha Jain to Motions to Dismiss by Wilson Sonsini Goodrich and Rosati, P.C. and J.P. Morgan Securities, Inc.;

5. Defendant J.P. Morgan Securities, Inc.'s Reply to Opposition to Motion to Dismiss Third Amended Complaint;

6. Defendant J.P. Morgan Securities, Inc.'s Request for Judicial Notice in Support of Defendant J.P. Morgan Securities, Inc.'s Reply to Opposition to Motion to Dismiss Third Amended Complaint;

7. Non-Washington Authorities cited in Defendant J.P. Morgan Securities, Inc.'s Reply to Opposition to Motion to Dismiss Third Amended Complaint.

The Court has also reviewed the records and files herein, including plaintiffs' Third Amended Complaint, and has considered the arguments of counsel at a hearing before this Court on April 28, 2006.

Being advised in this matter, the Court hereby finds that the Third Amended Complaint fails to state a claim upon which relief can be granted against defendant J.P. Morgan Securities, Inc. It is hereby ORDERED that defendant J.P. Morgan Securities, Inc.'s Motion to Dismiss is GRANTED, and that plaintiffs' Third Amended Complaint is dismissed with prejudice.

IT IS SO ORDERED.

DATED this 5th day of May, 2006.

/s/ Richard A. Jones
JUDGE RICHARD JONES

Presented by:

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By /s/ Michael R. Scott
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Hon. Richard A. Jones

SUPERIOR COURT OF WASHINGTON FOR KING COUNTY

| | |
|---|---|
| NAVEEN JAIN and ANURADHA JAIN,<br><br>Plaintiffs,<br><br>vs.<br><br>J.P. MORGAN SECURITIES, INC., a Delaware corporation, as successor in interest to Hambrecht & Quist LLC; and WILSON SONSINI GOODRICH & ROSATI, a California professional corporation,<br><br>Defendants. | Consolidated No. 03-2-32427-2 SEA<br><br>[Consolidated with 03-2-34789-2 SEA and 04-2-1655-0SEA]<br><br>ORDER GRANTING WILSON SONSINI'S MOTION TO DISMISS THIRD AMENDED COMPLAINT |

Pending before this Court is defendant Wilson Sonsini Goodrich and Rosati's Motion to Dismiss Third Amended Complaint. In connection with this motion, the Court has reviewed the following materials:

1. Defendant Wilson Sonsini Goodrich and Rosati's Motion to Dismiss Third Amended Complaint;

2. Declaration of Gregory J. Hollon in Support of Wilson Sonsini Goodrich and Rosati's Motion to Dismiss Third Amended Complaint and Exhibits A-C attached thereto;

3. Consolidated Opposition of Naveen and Anuradha Jain to Motions to Dismiss by Wilson Sonsini Goodrich and Rosati, P.C. and J.P. Morgan Securities, Inc.;

4. Declaration of Timothy G. Leyh in Support of the Consolidated Opposition of Naveen and Anuradha Jain to Motions to Dismiss by Wilson Sonsini Goodrich and Rosati, P.C. and J.P. Morgan Securities, Inc. and the exhibits attached thereto;

5. Defendant Wilson Sonsini Goodrich and Rosati's Reply in Support of Opposition to Motion to Dismiss Third Amended Complaint;

6. Jains' Request for Leave to File Surreply to New Argument in Wilson Sonsini Goodrich and Rosati's Reply in Support of Motion;

7. Defendant Wilson Sonsini's Opposition to Plaintiff's Request for Leave to File Surreply; and

8. The Jains' Reply in Support of Request for Leave to File Surreply to New Argument in Wilson Sonsini Goodrich and Rosati's Reply in Support of Motion and Jains' Surreply;

9. Wilson Sonsini's Reply to Surreply.

The Court has also reviewed the records and files herein, including plaintiffs' Third Amended Complaint, and has considered the arguments of counsel at a hearing before this Court on April 28, 2006.

Being advised in this matter, the Court hereby finds that the Third Amended Complaint fails to state a claim upon which relief can be granted against defendant Wilson Sonsini. It is hereby ORDERED that defendant Wilson Sonsini Goodrich and Rosati's Motion to Dismiss is

GRANTED, and that plaintiffs' Third Amended Complaint is dismissed with prejudice.

IT IS SO ORDERED.

DATED this 4th day of May, 2006.

/s/ Richard A. Jones
HONORABLE RICHARD JONES

Presented by:
McNAUL EBEL NAWROT & HELGREN PLLC

By /s/ Robert M. Sulkin
Robert M. Sulkin, WSBA #15425
Gregory J. Hollon, WSBA #26311

Attorneys for Defendant Wilson Sonsini Goodrich & Rosati, P.C.

Approved as to form
/s/ Timothy G. Leyh

The Honorable Richard Jones

SUPERIOR COURT OF WASHINGTON FOR KING COUNTY

NAVEEN JAIN and ANURADHA JAIN, husband and wife, and their Maritial Community,

Plaintiffs,

vs.

J.P. MORGAN SECURITIES, INC., a Delaware corporation, as successor in interest to Hambrecht & Quist LLC, *et al,*

Defendants.

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NAVEEN JAIN and ANURADHA JAIN,

Plaintiffs,

vs.

PERKINS COIE LLP,

Defendant.

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Case No. 03-2-32427-2 SEA

[Consolidated with 03-2-34789-2 SEA and 04-2-1655-0 SEA]

ORDER GRANTING PERKINS COIE'S MOTION TO DISMISS PLAINTIFFS' SECOND AMENDED COMPLAINT AND DENYING PLAINTIFFS' MOTION FOR PARTIAL SUMMARY JUDGMENT

This matter came for hearing on the motion of Perkins Coie LLP ("Perkins") to dismiss the Second Amended Complaint filed against it by plaintiffs Naveen and Anuradha Jain ("Plaintiffs"), and Plaintiffs' Motion for Partial Summary Judgment Striking Perkins Coie's Affirmative Defense of Federal Preemption With Respect to Plaintiffs' Litigation Malpractice Claims. The Court has reviewed the records submitted in regard to these motions, including but not limited to the following:

1. Perkins Coie's Motion to Dismiss Second Amended Complaint;

2. Declaration of Keith D. Petrak, Including Request for Judicial Notice in Support of Perkins Coie's Motion to Dismiss Second Amended Complaint;

3. Defendant J.P. Morgan Securities, Inc.'s Motion to Dismiss;

4. Defendant J.P. Morgan Securities, Inc.'s Request for Judicial Notice in Support of Defendant J.P. Morgan Securities, Inc.'s Motion to Dismiss;

5. Defendant Wilson Sonsini Goodrich and Rosati's Motion to Dismiss Third Amended Complaint;

6. Declaration of Gregory J. Hollon in Support of Wilson Sonsini Goodrich and Rosati's Motion to Dismiss Third Amended Complaint and Exhibits A-C attached thereto;

7. Consolidated Opposition of Naveen and Anuradha Jain to Motions to Dismiss by Wilson

Sonsini Goodrich and Rosati, P.C. and J.P. Morgan Securities, Inc.;

8. December 2, 2005 Order Denying Plaintiffs Motion: (1) To Strike Perkins Motion to Dismiss Litigation Malpractice Claims; and/or (2) To Strike Extra-Pleading Materials Presented in Support of That Motion; and/or (3) For a CR 56(f) Continuance of Motion Hearing until Following Completion of Expert Deposition Discovery; And Denying Plaintiffs Motion for Extension of Time to Respond to Perkins Coie's Motion to Dismiss Litigation Malpractice Claims

9. Defendant J.P. Morgan Securities, Inc.'s Reply to Opposition to Motion to Dismiss Third Amended Complaint;

10. Wilson Sonsini Goodrich and Rosati's Reply in Support of Motion to Dismiss Third Amended Complaint;

11. Plaintiff Jains' Opposition to Perkins to These Motion to Dismiss;

12. Plaintiffs, Motion for Partial Summary Judgment Striking Perkins Cooties Affirmative Defense of Federal Preemption with Respect to Plaintiffs' Litigation Malpractice Claims;

13. Plaintiffs' Offer of Intended and/or Hypothetical Proof Re: Proximate Cause Arguments Made in Perkins Motion to Dismiss;

14. Declaration of Robert J. Adolf;

15. Declaration of John A. Strait In Support of Jains' Motion to Strike, etc.;

16. Perkins Coie's Consolidated Reply in Support of Motion to Dismiss Second Amended Complaint and Opposition to Plaintiff's Motion for Partial Summary Judgment;

17. Plaintiffs' Reply in Support of Motion for Partial Summary Judgment Striking Perkins Coie's Affirmative Defense of Federal Preemption with Respect to Plaintiffs Litigation Malpractice Claims;

18. May 2, 2006 Letter from Larry Gagnes; and

19. May 3, 2006 letter from Bradley S. Keller.

Having considered the foregoing record and the arguments of counsel, and finding as a matter of law that Plaintiffs' Second Amended Complaint for Damages and Other Relief against Perkins fails to state a claim upon which relief may be granted, and that further amendment would be futile, it is hereby

ORDERED, ADJUDGED AND DECREED that Plaintiffs' motion is denied, Perkins' motion is granted, and Plaintiffs' claims against Perkins as set forth in Plaintiffs' Second Amended Complaint for Damages and Other Relief are hereby dismissed with prejudice.

DATED this 4th day of May, 2006.

/s/ Richard A. Jones
THE HONORABLE RICHARD JONES

Presented by:

BYRNES & KELLER LLP

By /s/ Keith D. Petrak

Peter D. Byrnes, WSBA #00446
Bradley S. Keller, WSBA #10665
Keith D. Petrak, WSBA #19159
*Attorneys for Defendant*
*Perkins Coie, LLP*

APPENDIX D

United States District Court, W.D. Washington.
Naveen and Anuradha JAIN, Plaintiffs,
v.
INFOSPACE, INC, et al., Defendants.
No. C03-2897P.

Filed Sept. 23, 2003.
Jan. 9, 2004.

represented by G. Val Tollefson, Danielson Harrigan & Tollefson, Seattle, WA, Lead Attorney, Attorney to be Noticed, John R Neeleman, Larry Steven Gangnes, Lane Powell Spears Lubersky, Seattle, WA, Lead Attorney, Attorney to be Noticed, Timothy G Leyh, Danielson Harrigan & Tollefson, Seattle, WA, Lead Attorney, Attorney to be Noticed, Randall Thor Thomsen, Danielson Harrigan & Tollefson, Seattle, WA, Attorney to be Noticed, for Naveen Jain, Plaintiff.
represented by G. Val Tollefson, John R Neeleman, Larry Steven Gangnes, Timothy G Leyh, (See above for address), Lead Attorney, Attorney to be Noticed, for Anuradha Jain, husband and wife, and the Marital Community, Plaintiff.
represented by Brian D Buckley, Stellman Keehnel, Gray Cary Ware & Freidenrich LLP, Seattle, WA, Lead Attorney, Attorney to be Noticed, for InfoSpace Inc, a Delaware corporation, Defendant.
represented by Brian D Buckley, Stellman Keehnel, (See above for address), Lead Attorney, Attorney to be Noticed, for Mellon Investor Services LLC, a New Jersey corporation, as successor in interest to ChaseMellon Shareholder Services, LLC, Defendant.
represented by David M Balabanian, McCutchen

Doyle Brown & Enersen, San Francisco, CA, Lead Attorney, Attorney to be Noticed, John D Pernick, Bingham Mccutchen (SF), San Francisco, CA, Lead Attorney, Attorney to be Noticed, Michael Ramsey Scott, Hillis Clark Martin & Peterson, Seattle, WA, Lead Attorney, Attorney to be Noticed, for JP Morgan Securities Inc, a Delaware corporation as successor in interest to Hambrecht & Quist LLC, Defendant.
represented by Brian D Buckley, Stellman Keehnel, (See above for address), Lead Attorney, Attorney to be Noticed, for Ellen Alben, Defendant.
represented by Brian D Buckley, Stellman Keehnel, (See above for address), Lead Attorney, Attorney to be Noticed, for Alex Alben, and their Marital Community, Defendant.

ORDER GRANTING PLAINTIFFS' MOTION TO REMAND

PECHMAN, J.
*1 This matter comes before the Court on Plaintiffs' motion to remand. (Dkt. No. 6.) Having reviewed all of the pleadings and supplemental materials and having heard oral argument on the matter, the Court GRANTS Plaintiffs' Motion to Remand. Defendants argue that the Plaintiffs' ("the Jains") state law tort claims are really claims for reimbursement or indemnification of the Jains' Section 16(b) liability under the Securities and Exchange Act ("the SEA" or "the Act"). According to Defendants, federal law bars indemnification for Section 16(b) liability. Based on this, Defendants maintain that there is removal jurisdiction under the artful pleading doctrine. However, Defendants have failed to meet the requirements of the artful pleading doctrine. The Jains'

claims are not necessarily federal in character. Nor is a federal question an element of their state law tort claims. Instead, Defendants' argument is properly characterized as a defense based on a federal question. As a defense, it cannot provide the basis for removal jurisdiction.

## BACKGROUND

This case stems from the *Dreiling v. Jain* case ("the *Dreiling* litigation"), C01-1528P. On May 14, 2003, this Court entered summary judgment against the Jains, concluding that they had engaged in prohibited short-swing trading in violation of Section 16(b) of the SEA. On August 22, this Court entered judgment against the Jains, ordering them to disgorge the profits from these trades, totaling approximately $200 million dollars plus prejudgment interest.

In August, the Jains filed this law suit in state court against two securities firms that worked with Infospace, Infospace's general counsel, and Infospace. The Jains claim that all of these Defendants were negligent and breached their fiduciary obligations to the Jains, which caused the damages that the Jains incurred as a result of the *Dreiling* litigation. They also seek equitable subrogation against all Defendants, and claim unjust enrichment against Infospace.

Defendants removed the Jains' D & O insurers suit. In their removal notice, Defendants claimed that the federal district court has removal jurisdiction because "plaintiffs' claims implicate and depend upon a substantial federal question.... [T]he Jains' claims

depend upon whether indemnity is available for Section 16(b) liability. The federal case law is clear that Section 16(b) liability cannot be indemnified."(Notice of Removal, ¶ 3)

ANALYSIS

The removal statute is strictly construed against removal jurisdiction. *Gaus v. Miles, Inc.,* 980 F.2d 564, 566 (9th Cir.1992)."Federal jurisdiction must be rejected if there is any doubt as to the right of removal in the first instance."*Id.* The removing party has the burden of proof that removal was proper. *Id*. When removal is premised on a federal question, the removing party must establish the federal nature of the claim.

Removal analysis begins with the well-pleaded complaint rule, in which federal question jurisdiction exists only when a federal question is present on the face of the plaintiff's properly plead complaint. *Rivet v. Regions Bank of La.,* 522 U.S. 470, 475 (1998) (citing *Caterpillar Inc. v. Williams,* 482 U.S. 386, 392 (1987)). Moreover, a plaintiff may defeat removal by choosing not to plead independent federal claims. *ARCO Envtl. Remediation v. Dep't of Health and Envtl. Quality,* 213 F.3d 1108, 1114 (9th Cir.2000). Both parties agree that neither of the complaints in these actions explicitly set forth a federal cause of action.

*2 Nonetheless, Defendants argue that this Court has removal jurisdiction under the artful pleading doctrine. A plaintiff may not defeat removal of a federal claim by artfully pleading it as a state claim or omitting to plead necessary federal questions. *Rivet,*

522 U.S. at 475,*Franchise,* 22. The artful pleading doctrine applies when either 1) federal law completely preempts state law, 2) the claim is necessarily federal in character, or 3) the right to relief depends on the resolution of a substantial, disputed federal question. *ARCO,* 213 F.3d at 1114. (A recent Ninth Circuit opinion combined 2) and 3) into one standard, with two sub-parts. *Lippitt v. Raymond James Fin. Servs.,* 340 F.3d 1033, 1041-42 (9th Cir.2003). This appears to be merely a semantic difference .) Both parties agree that the SEA does not completely preempt the field.

However, Defendants contend that the Jains' claims are necessarily federal in character and that the Jains' right to relief depends on resolution of a substantial, disputed federal question. The Defendants' two arguments stem from their basic premise that the Jains' claims are really claims for reimbursement or indemnification disguised as state law claims. Defendants cite a Tenth Circuit case for the proposition that the SEA prohibits indemnification for Section 16(b) liability. *First Golden Bancorporation v. Weiszmann,* 942 F.2d 726 (10th Cir.1991). Therefore, according to Defendants, the Jains must show that their Section 16(b) liability can be indemnified. In other words, indemnification for Section 16(b) liability is a condition precedent to Jains' state law claims.

In contrast, if a defendant's basis for removal jurisdiction is a federal question defense, as opposed to an affirmative federal claim that plaintiff disguised as a state law claim, there is no removal jurisdiction. It is settled law that a defense based on a federal question does not establish federal jurisdiction. This

is true "even if the defense is anticipated in the plaintiff's complaint and both parties agree that the defense is the only question truly at issue in the case." *Franchise Tax Bd. of Cal. v. Constr. Laborers Vacation,* 463 U.S. 1, 14 (1983)."A defense is not part of a plaintiff's properly pleaded statement of his or her claim." *Rivet,* 522 U.S. at 475. The Jains contend that Defendants' argument is a federal question defense.

*I. The Jains' Claims Are Not Necessarily Federal in Character*

Defendants' "necessarily federal" argument rests on two provisions of the SEA. First, Section 16(b) liability cannot be waived or altered by agreement. 15 U.S.C. § 78cc(a). Second, federal courts have exclusive jurisdiction over all suits "brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder." § 78aa. According to Defendants, Plaintiffs' claims, which are really an attempt to seek reimbursement or indemnification for their Section 16(b) liability, undermine the prohibition on waiving or altering liability by agreement. In essence, Defendants argue that by seeking reimbursement or indemnification from the securities firms and Infospace for the Jains' Section 16(b) liability, the Jains would be escaping their Section 16(b) liability, or "shifting their entire 16(b) liability onto Defendants," in violation of § 78cc(a). Moreover, by doing so, they are attempting to escape enforcement of their Section 16(b) liability. This challenge to the enforcement of Section 16(b) liability triggers the exclusive jurisdiction provision in § 78aa.

*3 A similar issue was addressed by the Ninth Cir-

cuit in *Lippitt.*The plaintiff alleged that marketing by brokerage firms of a "callable certificate of deposit" violated state unfair competition laws. Defendant claimed that the exclusive federal jurisdiction provision in § 78aa of the SEA supported removal jurisdiction. 340 F.3d at 1036. The Ninth Circuit rejected this argument. The court held that plaintiff's claims did not fall within the scope of § 78aa because plaintiff was not attempting to enforce any provision of the Act. Rather, he sought to enforce state law. *Id.* at 1037.

Like the plaintiff in *Lippitt,* the Jains' claims do not touch upon the enforcement of their Section 16(b) liability. They are not seeking through this lawsuit to challenge their Section 16(b) liability or to escape enforcement of their Section 16(b) liability. In fact, the Jains' Section 16(b) liability is the premise upon which their state law claims rest. If they were challenging the validity of their Section 16(b) liability, they could not allege negligence by Infospace, its general counsel, and two securities firms for "causing" that liability. This lawsuit does not challenge the liability itself; success on the merits would not negate the fact that they were held strictly liable for Section 16(b) violations. Instead, the Jains are merely seeking to hold other parties accountable for negligence in causing the damages they incurred as a result of their Section 16(b) liability. Like the plaintiff in *Lippitt,* the Jains' state law claims do not fall within the scope of the Act. As such, the exclusive jurisdiction provision of § 78aa is not triggered. Defendants' argument that the Jains are directly challenging a right or liability under the SEA mischaracterize the Jains' claims.

The Court does not find *Bunker Ramo-Electra Corp. v. Fairchilds Industries, Inc.* persuasive on this issue. 639 F.Supp. 409 (D.Md.1986). That court held in dicta that indemnification for Section 16(b) liability would violate § 78cc because it would allow the violators to waive their Section 16(b) liability "since they would not have to return their short-swing profits...." *Id.* at 419.First, the Jains have alleged negligence, not indemnification. Despite the fact that the result be the same, these are legally distinct causes of action. Second, the Jains must disgorge their short-swing profits regardless of whether they can prove as a matter of law and fact that the Defendants were negligent, causing the damages the Jains incurred in the *Dreiling* litigation. They are not waiving their Section 16(b) liability.

Defendants' reliance on *ARCO* is equally misplaced. In determining whether a claim is necessarily federal in character, *ARCO* looked to the language of the federal statute upon which the defendant premised removal jurisdiction. 213 F.3d at 1115. Like the SEA, the federal statute at issue in *ARCO,* the Comprehensive Environmental Responsibility, Compensation, and Liability Act (the Superfund legislation), conferred exclusive federal jurisdiction in limited circumstances. Under this Act, exclusive federal jurisdiction existed when a plaintiff's claims challenged a Superfund cleanup. The court held that an action challenged Superfund cleanup if the action was related to the goals of the cleanup. Plaintiff sought disclosure of certain cleanup documents. As such, the plaintiff's claim was not related to Superfund cleanup goals. Therefore, plaintiff's claim was not necessarily federal in character. *Id.* Defendants seize upon this language and argue that, unlike the

plaintiff's claims in *ARCO,* the Jains' claims directly challenge the goals of Section 16(b) liability by seeking to pass their liability on to other parties, in violation of § 78cc. However, the Jains' claims do not directly challenge the strict liability goal of Section 16(b). As discussed above, their Section 16(b) liability is the premise of their state law claims. Prevailing on their state law claims would not negate the fact that they were deemed liable under Section 16(b).

*4 For this reason, this is case is not analogous to *Gilson v. Chock Full O'Nuts Corp.* 331 F.2d 107 (2d Cir.1964). In *Gilson,* the Second Circuit concluded that awarding attorney's fees to shareholder's counsel who brought a Section 16(b) violation to the attention of the corporation was within the scope of the Act because it was a remedy incidental to the federal right created by Section 16(b). Unlike attorney's fees, which are appropriately deemed instrumental to the enforcement of Section 16(b), barring a person found liable under Section 16(b) from alleging negligence against another for causing the Section 16(b) damages incurred is not instrumental to the enforcement of Section 16(b). While it may or may not undermine the policy behind Section 16(b), that argument is more appropriately characterized as a federal question defense.

*II. Federal Law Is Not an Element of the Jains' State Law Claims*

Under the third prong of the artful pleading doctrine, federal jurisdiction exists over a state law claim if the right to relief depends on the resolution of a substantial, disputed federal question. In analyzing a state claim under this prong, both *Lippitt*

and *ARCO* look to whether a substantial, disputed question of federal law is a *necessary element* of the plaintiff's state law claim. Without this requirement, it would be difficult to impossible to determine when an issue is a substantial and disputed federal question supporting removal jurisdiction versus when an issue is a defense that happens to raise a substantial and disputed federal question upon which the merits of the case may turn, but which cannot support removal jurisdiction. The law is clear that a federal question defense cannot support removal jurisdiction, no matter how central it is to the resolution of plaintiff's claims, nor how novel or complex the federal question may be. *Rivet,* 522 U.S. at 475, *Franchise Tax Bd.,* 463 U.S. at 14. Without a clear and systematic way of distinguishing an artfully plead federal claim from a federal question defense, resolution of the kinds of questions presented in this motion would lead to inconsistent and seemingly random results wherein removal jurisdiction would sometimes exist but not others. The necessary element requirement provides a clear and systematic way to distinguish the two. In *Lippitt,* the court reviewed the elements of plaintiff's state law unfair competition claim, finding that "his allegations [were] sufficient ... to sustain the elements of his [unfair competition] claim without resort to federal law." 340 F.3d at 1043. In *ARCO,* the court held that the plaintiff's right to relief seeking disclosure of state agency documents was not predicated on federal law. 213 F.3d at 1116. Like these two cases, federal law is not a necessary element of the Jains' claims in either of their complaints.

The Jains allege that two securities firms, Infospace's general counsel, and Infospace were negligent

and breached their fiduciary duties in handling the transactions that lead to the short-swing purchases. The Jains' claims against these Defendants rests solidly in tort law. Defendants argue that the Jains' claims in this case are indemnity or reimbursement claims in disguise. However, Defendants have presented no authority indicating that the elements of negligence and breach of fiduciary duty are the same as those for indemnification. Indemnity is defined as "a duty to make good any loss, damage, or liability incurred by another; the right of an injured party to claim reimbursement for its loss, damage, or liability from a person who has such a duty; reimbursement or compensation for loss, damage, or liability in tort...." *Black's Law Dictionary* (7th ed.1999). Thus, it seems that a claim for indemnification or reimbursement only requires showing that the Defendants had an obligation to "make good" or reimburse the Jains and have failed to fulfill that obligation. The Jains have not alleged this. They have alleged negligence and breach of fiduciary duty, which requires them to show that the Defendants owed the Jains a duty of care, the Defendants breached that duty, and the breach was the actual and proximate cause of damages suffered by the Jains. While the ultimate outcome might be the same if the Jains prevail on their state law claims-i.e. the Jains will recover the amount of damages they incurred as Section 16(b) liability-this does not mean that the Jains' negligence and breach of fiduciary duty state law claims are equivalent to claims for indemnification or reimbursement.

*5 Defendants argue that two of the elements of the Jains' negligence claims depend on federal law, namely causation and damages. According to Defen-

dants, only insider-traders can be the legal cause of Section 16(b) liability. Therefore, the Jains must prove that Defendants were the legal cause of their Section 16(b) liability. This mischaracterizes the Jain's claims. The Jains are not claiming that the Defendants caused their liability, but rather that the Defendants caused the prohibited short-swing purchases, which lead to the assignment of Section 16(b) liability. Similarly, Defendants argue that the Jains have not suffered legally-cognizable damages because they were never entitled to the short-swing profits in the first place. However, contrary to Defendant's argument, the Jains' damages are an established fact based on the judgment in the *Dreiling* litigation. Defendants argument that such damages are not legally cognizable is a defense to the damage element that the Jains must prove. The Court notes that state court judges commonly rule on complex and novel issues of federal law. There is no reason to suggest that only federal court judges have the ability to decide the issues presented in this case.

Lastly, *ARCO'* s analysis of the necessary element requirement provides further support for this Court's conclusion. In holding that the plaintiff's claims was not predicated on federal law, the court distinguished two cases where federal question jurisdiction existed for state law claims, both of which are equally distinguishable here. 213 F.3d at 1116. In one, an element of the plaintiff's state law tort claim was the breach of a duty created by federal law. *Sable v. General Motors Corp.*, 90 F.3d 171 (6th Cir.1996). In the other, an element of the plaintiff's state law breach of warranty claim was an agreement created by federal law. *Marcus v. AT & T,* 138 F.3d 46 (2d Cir.1998). Here, the contract providing

for Section 16(b) liability was not created by federal law, regardless of the fact that it covered a federal law violation.

## CONCLUSION

Defendants have failed to establish removal jurisdiction under any of the prongs of the artful pleading doctrine. The Jains' state law tort claims are not necessarily federal in character. Nor is a federal question an element of their state law tort claims. Instead, Defendants' argument that the Jains' claims are really claims for reimbursement or indemnification barred by federal law is a federal question defense. As such, it cannot provide the basis for removal jurisdiction. Therefore, the Court GRANTS Plaintiffs' motion to remand.

The clerk is directed to provide copies of this order to all counsel of record.

W.D.Wash.,2004.
Jain v. Infospace, Inc.
Not Reported in F.Supp.2d, 2004 WL 212999 (W.D.Wash.)

## APPENDIX E

United States District Court, W.D. Washington.
Thomas R. DREILING, on behalf of INFOSPACE, INC., Plaintiff,
v.
Naveen **JAIN** and Anuradha **Jain**, husband and wife, and their marital community, the **Jain** Family Irrevocable Trust, the Naveen **Jain** Grat No. 1 Trust, and the Anuradha **Jain** Grat No. 1 Trust, Defendants,
and
Infospace, Inc., Nominal Defendant.
**No. C01-1528P.**

Aug. 22, 2003.

In action seeking disgorgement of profits earned by corporate insiders in short-swing trades, plaintiff filed motion for judgment, and defendants filed motion for partial summary judgment. The District Court, Pechman, J., held that: (1) in calculating short-swing profits required to be disgorged, purchase price of the shares transferred from trust accounts to insiders personal accounts was $0; (2) insiders could not avoid liability for short-swing profits by returning the money to the trusts; and (3) balance of equities favored award of prejudgment interest.

Motions granted in part and denied in part.

***1236** William H. Beaver, Jr., Karr Tuttle Campbell, Seattle, WA, for Naveen Jain Grat No 1 Trust, Defendant.
Beth Ann Colgan, Harry H. Schneider, Jr., Brent Snyder, Perkins Coie, Seattle, WA, for Jain Family

Irrevocable Trust, Defendant.
Timothy P Crudo, Paul H Dawes, David M. Friedmam, Latham & Watkins, San Francisco, CA, Mark Maynes, Stokes Lawrence, Seattle, WA, Kevin Michael Paulich, Wolfstone, Panchot & Block, Seattle, WA, John C. Tang, Aaron Levine & Associates, Washington, DC, for InfoSpace Inc, Interested Party.
Judith A Endejan, Graham & Dunn, Seattle, for Seattle Times Company, Intervenor.
Christine E Gardiner, Karr Tuttle Campbell, Seattle, for Anuradha Jain Grat No 1 Trust, Defendant.
Douglas W Greene, Barry M. Kaplan, Perkins Coie, Seattle, for Kellett Partners LP, Stiles A Kellett, Jr, Defendants.
Arthur W. Harrigan, Jr., G. Val Tollefson, Danielson Harrigan & Tollefson, Seattle, WA, for Anuradha Jain, Defendant.
Jonathan P Meier, Stephen John Sirianni, Richard E. Spoonemore, Sirianni & Youtz, Seattle, WA, for Thomas R Dreiling, Plaintiff.
Elaine L Spencer, Graham & Dunn, Seattle, WA, for Seattle Times Company, Intervenor.

ORDER GRANTING PLAINTIFF'S MOTION FOR ENTRY OF JUDGMENT AND DENYING DEFENDANTS' MOTION FOR PARTIAL SUMMARY JUDGMENT

PECHMAN, District Judge.
The Court having concluded as a matter of law that Defendants are liable for short-swing trades, Plaintiff moves for entry of judgment against Defendants Naveen and Anuradha Jain ("the Jains" or "Jain Defendants"). (Dkt. No. 140.) The Jain Defendants move for partial summary judgment that they engaged in no short-swing trades, and alternatively

that they realized no profit on the trades. (Dkt. No. 196.) Plaintiff moves to strike numerous declarations, exhibits, and briefing by Defendants as impermissibly seeking reconsideration of the Court's prior order on liability. (Dkt. No. 198.) Because Defendants may not attempt to relitigate liability at this stage of the proceeding, Plaintiff's motion to strike is GRANTED in part. Because the Jain Defendants engaged in short-swing trades by transferring for no cost millions of shares from Trust accounts to personal accounts, they are required to disgorge the profit from these trades. Accordingly, Plaintiff's motion for entry of judgment is GRANTED and the Jain Defendants'*1237 motion for partial summary judgment is DENIED.

## BACKGROUND

On the parties' stipulation to present the issue of liability to the Court on summary judgment, the Court concluded that the Jain Defendants engaged in prohibited short-swing trades in violation of Section 16(b) of the 1934 Securities and Exchange Act, 15 U.S.C. § 78p(b). At issue now is the Jain Defendants' disgorgement of the profit from their short-swing trades, as well as prejudgment interest on that profit. In its prior order, the Court concluded that, in December 1998, Mr. Jain purchased, for the purposes of Section 16(b), 1,000,000 shares of InfoSpace stock through his agreement to place Trust shares into an escrow account to satisfy a personal obligation. The Court also concluded that, on May 24, 1999, the Jains purchased 2,490,472 shares of InfoSpace stock by transferring these shares from the Trusts to their personal brokerage accounts. There is no dispute regarding the Jains' sale of In-

foSpace stock within six months of the above purchases. On April 6, 1999, the Jains sold 1,000,000 shares of InfoSpace stock, receiving $85,600,000.00. On April 12, 1999, the Jains sold 210,000 shares of InfoSpace stock, receiving $17,955,000.00. On May 13, 1999, the Jains sold 1,800,000 shares of Infospace stock, receiving $98,966,696.05. In light of this Court's prior order, and accounting for stock splits, the Jains within six months purchased more shares than they sold, so that all profits realized from the above sales of $202,551,696.05 must be disgorged.

## ANALYSIS

This matter comes before the Court on summary judgment. Summary judgment is not warranted if a material issue of fact exists for trial. *Warren v. City of Carlsbad,* 58 F.3d 439, 441 (9th Cir.1995), *cert. denied,* 516 U.S. 1171, 116 S.Ct. 1261, 134 L.Ed.2d 209 (1996). The underlying facts are viewed in the light most favorable to the party opposing the motion. *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.,* 475 U.S. 574, 587, 106 S.Ct. 1348, 89 L.Ed.2d 538 (1986). "Summary judgment will not lie if ... the evidence is such that a reasonable jury could return a verdict for the nonmoving party." *Anderson v. Liberty Lobby, Inc.,* 477 U.S. 242, 248, 106 S.Ct. 2505, 91 L.Ed.2d 202 (1986).

### *I. Plaintiff's Motion to Strike*

Plaintiff moves to strike: (1) 15 declarations filed by Defendants on June 23, 2003, except for paragraphs 1-5, 16-17, 28, and 29, 44 of the Naveen Jain Declaration; (2) all exhibits to these declarations except for No. 25 to Mr. Jain's Declaration; (3) page 1

through page 11 ln. 10, and page 15 ln. 8 through page 20 ln. 17, of Mr. Jain's opposition to Plaintiff s motion for entry of judgment; (4) the Anuradha Jain and Trusts' opposition to the motion for entry of judgment; and (5) the Jain Defendants' motion for partial summary judgment.

The Court largely agrees with Plaintiff that the majority of Defendants' briefing is an untimely attempt to reconsider this Court's summary judgment order on liability. The Court has already denied reconsideration of liability, and all of the above motions, declarations, and exhibits come outside the ten-day period for reconsideration. Local Rule CR 7(h)(2). Anuradha Jain and the Trusts submit a brief that contests that there was a change in beneficial ownership, even though this issue was decided on summary judgment. Mr. Jain also contends that there is no purchase without an exchange of consideration, even though this was also addressed on summary judgment. Mr. Jain again raises the argument, rejected on reconsideration, that there was no purchase because the ***1238** transactions were rescinded. Defendants make numerous new arguments regarding how trusts are regulated under Washington law, none of which were pled on summary judgment, and none of which are relevant to a determination of liability or damages under Section 16(b). In pari delicto is a new defense to liability that was not pled or argued on summary judgment or reconsideration. In sum, Defendants raise issues already decided, as well as new arguments, well past the date for reconsideration. The Court will not entertain these untimely submissions and allow Defendants to relitigate liability.

The only issue properly before the Court at this time is the question of judgment. Accordingly, Plaintiff's motion to strike is GRANTED in part. The Court strikes the 15 declarations filed by Defendants on June 23, 2003, and all exhibits to these declarations, except for paragraphs 5, 28, and 29 and Exhibit No. 25 of the Naveen Jain Declaration. Pages 1 through 11 ln. 10 and page 15 ln. 20 through page 20 ln. 17 of the Jains' opposition to Plaintiff's motion for entry of judgment are stricken. The Court strikes pages 2 to 11 ln. 6 of Anuradha Jain and the Trust's opposition to Plaintiff's motion for entry of judgment. The Court strikes page 6 ln. 10 to page 10 ln. 4, and page 11 ln. 16 to page 14 ln. 6, of the Jain Defendants' motion for partial summary judgment.

*II. Entry of Judgment*

[1][2][3] Section 16(b) was enacted for the purpose of preventing the unfair use of information which may have been obtained by a statutory insider through his or her relationship to the issuing corporation. *Kay v. Scientex Corp.*, 719 F.2d 1009, 1012 (9th Cir.1983). Congress recognized that short-swing speculation by stockholders with advance, inside information would threaten the goal of the Securities Exchange Act to insure the maintenance of fair and honest markets. *Id.* Section 16(b) was aimed at protecting the public by preventing directors, officers, and principal stockholders of a corporation from speculating in the stock on the basis of information not available to others. *Id.* (citations and quotations omitted). Under the statute, all profit realized by the short-swing trades is disgorged to the corporation, and the Court may also allow recovery of prejudgment interest. *Whittaker v. Whittaker Corp.*, 639

F.2d 516, 522, 533 (9th Cir.1981), *cert. denied,* 454 U.S. 1031, 102 S.Ct. 566, 70 L.Ed.2d 473 (1981). Section 16(b) is a strict liability statute that "operates mechanically, and makes no moral distinctions, penalizing technical violators of pure heart, and bypassing corrupt insiders who skirt the letter of the prohibition." *Magma Power Co. v. Dow. Chem. Co.,* 136 F.3d 316, 320-21 (2d Cir.1998).

*A. Calculating profit*

[4] "For the purpose of preventing the unfair use of information which may have been obtained by ... [an insider], any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security ... within any period of less than six months ... shall inure to and be recoverable by the issuer." 15 U.S.C. § 78p(b). "Profit" is understood in its ordinary sense as "the excess of returns over expenditures ... the excess of the price received over the price paid for the goods sold." *S & S. Realty Corp. v. Kleer-Vu Indus., Inc.,* 575 F.2d 1040, 1043 (2d Cir.1978).

[5] In calculating the profit realized as a result of stock purchases, courts use the "lowest purchase price, highest sale price" method. *Whittaker,* 639 F.2d at 530. Under this rule, called the *Smolowe* rule after the leading case on the matter, the highest sales price is matched with the lowest purchase price in any given six month period. *Id.* at 530-31. In analyzing the legislative ***1239** history of the statute, the court in *Smolowe* concluded:

The statute is broadly remedial. Recovery runs not to the shareholder, but to the corporation. We must

suppose that the statute was intended to be thoroughgoing, to squeeze all possible profits out of stock transactions, and thus to establish a standard so high as to prevent any conflict between the selfish interest of a fiduciary officer, director, or stockholder and the faithful performance of his duty. The only rule whereby all possible profits can be surely recovered is that of lowest price in, highest price out within six months.

*Smolowe v. Delendo Corp.*, 136 F.2d 231, 239 (2d Cir.1943), *cert. denied*, 320 U.S. 751, 64 S.Ct. 56, 88 L.Ed. 446 (1943).

[6] Calculating the profit in this case is straightforward. The Jains paid nothing for shares that were transferred, therefore their purchase price is $0. Within six months of acquiring the InfoSpace shares for nothing, the Jains sold shares for $202,551,696.05. Consistent with the definition of profit and the "lowest in, highest out" rule, therefore, the Jains' profit is calculated at $202,551,696.05.

The Jains contend that, even though they acquired the InfoSpace shares for nothing, the Court should nonetheless impute a price to the shares because the Jains ultimately returned the shares to the Trust. A number of cases recognize that a value may be imputed to shares when non-monetary consideration is given. For example, courts will place a dollar value on intangible assets or non-monetary consideration, such as hours worked for a corporation in return for stock. *See, e.g., Truncale v. Blumberg*, 88 F.Supp. 677 (S.D.N.Y.1950). In this matter, however, the Jains gave neither monetary nor intangible consideration for the InfoSpace shares. The shares were

transferred to the Jains for no consideration. As the Court decided on summary judgment and reconsideration, such a transfer-even if it was an unauthorized transfer, with no consideration given, and later rescinded-can be a purchase for the purpose of Section 16(b) because of the possibility for speculative abuse. Because no consideration was given for the InfoSpace shares, the Jains' cost was nothing, and therefore to "squeeze all possible profits out of" the stock transactions requires disgorgement of $202,551,696.05.

Defendants' proposal that the Court should impute the market price of the InfoSpace shares at the time the Jains transferred the shares from the Trusts to themselves, or alternatively at the time the Jains returned the shares to the Trusts, is particularly problematic. This suggestion fails to capture the profit that the Jains realized from the transfers, because the market price of the shares at the time of transfer or return is not related to the profit that an insider might make in transferring shares to a personal account. To illustrate, an insider might transfer a thousand shares valued at $10 each, speculate with those shares to make a profit by buying and selling when the shares are valued at less than $10 each, and then return the shares when they are again valued at $10 each. In such a case, the profit made by the insider through speculation has no relation to the market value of the shares at the time of transfer or return. Such an application of Section 16(b) not only fails to disgorge the profits realized by the transfer, but invites abuse and manipulation of the statute.

[7] The Jains argue that Plaintiff's proposed judg-

ment is unconstitutional and punitive because it forces disgorgement of all profit on the sale of the InfoSpace shares even though the Jains eventually returned an equal number of shares to the Trusts. Because the share transfers were unauthorized, the Jain Defendants contend ***1240** that had they not returned the shares, they might have faced liability to the Trusts for conversion. The Jains insist that, because the transfers were rescinded, disgorgement of all profit would in effect mean the Jains paid twice for the shares at issue.

[8][9][10] The Jains cannot use their conduct in avoiding liability to the Trusts under state or other federal law as a method to avoid Section 16(b) disgorgement. "The determination that an act is illegal under state law and the Internal Revenue Code does not make the rescission of that act free from federal securities law problems.... The exercise of the duty to rescind ... does not immunize the rescinding transaction from securities law liability." *Oliff v. Exchange Int'l Corp.*, 449 F.Supp. 1277, 1293 (N.D.Ill.1978), *aff'd*, 669 F.2d 1162 (7th Cir.1980), *cert. denied sub nom.*, 450 U.S. 915, 101 S.Ct. 1358, 67 L.Ed.2d 340 (1981). The Jains' conduct in transferring shares simply subjected them to multiple legal obligations. "The fact that other state or federal laws may have affected a penalty or caused defendants in a section 16(b) proceeding to take a particular action does not prevent a finding of section 16(b) liability." *Id.* As this Court ruled on summary judgment and on reconsideration, the Jains' transfers of the stocks from the Trusts and subsequent short-swing sales subjected them to liability because of the possibility of speculative abuse. The collateral obligations the Jains acquired regarding the transferred shares, and

the actions they took in response to these obligations, do not impact the calculation of short-swing profits. Therefore, the profit realized by the Jains by short-swing trades is $202,551,696.05. Although courts recognize that Section 16(b) may be harsh in application, Defendants cite no authority for finding the statute unconstitutional. Section 16(b) has been applied for decades, and this Court declines the invitation to strike the statute as unconstitutional.

*B. Prejudgment Interest*

[11][12] Whether prejudgment interest is awarded as part of a Section 16(b) recovery is a question of fairness to be answered by balancing the equities. *Whittaker,* 639 F.2d at 533. Although prejudgment interest is generally considered a part of Section 16(b) recovery, it is denied when its exaction would be inequitable. *Id.* The burden is on the insider to "show there is an overriding inequity in allowing interest in order to overcome the granting of interest." *Id.*

[13] In weighing the equities, the Court takes into account several factors: (1) whether the insider acted innocently or knowingly; (2) whether the insider repaid the corporation promptly upon demand; and (3) whether there has been substantial delay caused by the insider. *Whittaker* at 533-34.

*1. Appropriateness of Prejudgment Interest*

[14][15] The Court's consideration of the first factor is not a one-dimensional question of subjective good or bad faith. *Whittaker,* 639 F.2d at 533. The type and degree of the insider's inadvertence, the position

of the insider in the corporation, and other circumstances of each case are considered. *Id.* Even when bad faith may have been absent, interest is still sometimes awarded. *Id.* The insider's good faith must be shown; bare allegations are not sufficient. *Id.*

[16] The Court cannot conclusively determine whether the Jains acted in either good faith or bad faith. However, Mr. Jain's status as a key insider weighs in favor of prejudgment interest. Mr. Jain ***1241** was the founder, Chairman of the Board of Directors, and CEO of InfoSpace. The Jains claim that they were victims of a combination of errors and oversights by others. Nonetheless, without the participation of the Jains, the purchases would not have happened. The Jains transferred shares to their personal accounts by signing letters of authorization and claim to have failed to notice the discrepancies in their account statements. Mr. Jain personally signed SEC filings representing that he had placed shares into escrow. Although the Jains may not have acted in bad faith, they clearly were not diligent in their transactions with the Trusts.

The second factor rewards an insider who repays the corporation promptly upon demand. Prompt payment has been taken as betokening good faith and justifying denial of interest, especially when the prompt repayment means the corporation has not lost use of the money for a long time. *Whittaker,* 639 F.2d at 534.

The second factor favors the Plaintiff. The Jains did not offer to repay the profits upon filing of the lawsuit. Though it is important to note that the corpora-

tion did not decide to bring suit, the corporation nonetheless has been deprived of the use of the money at issue for several years because of the Jains' actions.

The third factor in balancing the equities is the length of time involved. When there has been substantial delay between transactions and complaint or between complaint and judgment, courts consider who was responsible for the delay an important factor in allowing interest for such periods. *Whittaker*, 639 F.2d at 534.

Considerations of delay favor an award of prejudgment interest. Several years have passed since the complaint and this ruling on judgment. The Court ultimately agrees with the liability and judgment arguments that Plaintiff advances in this litigation. While it is understandable that Defendants would litigate this matter, they are nonetheless responsible for the delay between complaint and judgment.

Defendants have failed to meet their burden of showing that an award of prejudgment interest is inequitable. The factors to weigh in deciding to award prejudgment interest favor Plaintiff. Defendants have enjoyed the profits from the short-swing trade for years, and have had the opportunity to invest and earn from these profits. Accordingly, the Court GRANTS Plaintiff's request for prejudgment interest.

*2. Calculation of Interest*

In awarding prejudgement interest, the Ninth Circuit favors application of the federal post-judgment interest rates specified in 28 U.S.C. § 1961. *Western*

*Pacific Fisheries, Inc. v. S.S. President Grant,* 730 F.2d 1280, 1289 (9th Cir.1984). The parties do not dispute that interest for transactions completed on April 6 is calculated at 4.732% per year, compounded yearly, and for transactions completed on May 24, 1999 the interest is 4.727%. Neither have the parties disputed that interest should be awarded from the date of the sales which produced the profit that the Jains have since held.

The Jains realized $85,600,000.00 in profit from the April 6, 1999 sale. The Court awards prejudgment interest at a rate of 4.732% per year from the date of the sale to the date of this order. Defendants have not contested that the calculation of this award amounts to $18,297,057.00 plus $13,352.00 for each day after June 13, 2003. Therefore, the Court awards $18,297,057.00 plus $921,288.00 in prejudgment interest, for a total of $19,218,345.00 on the April 6, 1999 sale.

The Jains realized $116,951,696.05 in profit from the April 6 and May 13, 1999 sales and the May 24, 1999 purchase. The ***1242** Court awards prejudgment interest of 4.727% per year on this amount from the date of the purchase to the date of this order. Defendants have not contested that the calculation of this award amounts to $24,095,542.98 plus $18,219.26 for each day after June 13, 2003. Therefore, the Court awards $24,095,542.98 plus $1,257,128.94, for a total of $25,352,671.92 in prejudgment interest on the May 24, 1999 purchase.

*C. Total Judgment*

The Court orders disgorgement of $202,551,696.05 in

profit. Prejudgment interest on this sum amounts to $44,571,016.92. Total judgment is for $247,122,712.97.

*III. Separate Judgment Under Rule 54(b)*

Plaintiff requests that the Court enter separate judgment on the claims against the Jain Defendants in accordance with Fed.R.Civ.P. 54(b). "[T]he Court may direct the entry of a final judgment as to one or more but fewer than all of the claims or parties only upon an express determination that there is no just reason for delay and upon an express direction for the entry of judgment." Fed.R.Civ.P. 54(b). The only Defendants remaining after resolving this motion are the Trusts. Withholding judgment until the claims of the Trusts are resolved only serves to delay any appeal of the claims of the Jain Defendants, who have already indicated through a motion for interlocutory appeal that they wish to appeal this Court's decision. There being no just reason to delay entry of judgment, the Court will enter separate judgment on the claims against the Jain Defendants.

CONCLUSION

The Jain Defendants engaged in short-swing trades by transferring for no consideration millions of InfoSpace shares from Trust accounts to personal accounts within six months of selling InfoSpace shares. Under Section 16(b) the Jain Defendants are required to disgorge the profit from these trades. Accordingly, Plaintiff's motion for entry of judgment is GRANTED and the Jain Defendants' motion for partial summary judgment is DENIED. The Court orders disgorgement of $202,551,696.05 of profit from

short-swing trades. Prejudgment interest on this sum amounts to $44,571,016.92, for a total judgment of $247,122,712.97. The Court authorizes publication of notice of Plaintiff counsel's forthcoming request for fees in The Wall Street Journal and The Seattle Times.

W.D.Wash.,2003.
Dreiling ex rel. Infospace, Inc. v. Jain
281 F.Supp.2d 1234

END OF DOCUMENT

United States District Court, W.D. Washington.
Thomas R. DREILING, on behalf of INFOSPACE, INC., Plaintiff,
v.
Stiles A. KELLETT, Jr., an individual; and Kellett Partners LP, a limited partnership, and Naveen **Jain** and Anuradha **Jain**, husband and wife, and their marital community, the **Jain** Family Irrevocable Trust, the Naveen **Jain** Grat No. 1 Trust, and the Anuradha **Jain** Grat No. 1 Trust, Defendants,
and
Infospace, Inc., Nominal Defendant.
**No. C01-1528P.**

May 14, 2003.
Order Denying Reconsideration July 9, 2003.

Shareholder brought suit against settlors of trusts, consisting of corporation's shares, seeking to recover on behalf of corporation short-swing profits allegedly made by settlors based on theory that they purchased securities when they moved them from trust to an escrow and into individual trading accounts. Parties moved and cross moved for summary judgment. The District Court, Pechman, J., held that: (1) settlors were not beneficial owners, for purposes of claims that transactions were changes in beneficial ownership not subject to short-swing profits; (2) movement of shares from trust to escrow counted as purchase for short-swing profit purposes; (3) no gifts were involved; and (4) there was valid escrow, precluding claim of no liability because of no escrow.

Judgment for shareholder.

*1216 William H. Beaver, Jr.,Karr Tuttle Campbell, Seattle, WA, for Naveen Jain Grat No 1 Trust, Defendant.

Beth Ann Colgan, Harry H. Schneider, Jr., Brent Snyder, Perkins Coie, Seattle, WA, for Jain Family Irrevocable Trust, Defendant

Timothy P Crudo, Paul H Dawes, David M. Friedman, Latham & Watkins, San Francisco, CA, Mark Maynes, Stokes Lawrence, Seattle, WA, Kevin Michael Paulich, Wolfstone, Panchot & Block, Seattle, WA, John C Tang, Aaron Levine & Associates, Washington, DC, for InfoSpace Inc, Interested Party.

Judith A Endejan, Graham & Dunn, Seattle, WA, Elaine L Spencer, Graham & Dunn, Seattle, WA, for Seattle Times Company, Intervenor.

Christine E Gardiner, Karr Tuttle Campbell, Seattle, WA, for Anuradha Jain Grat No 1 Trust Defendant.

Douglas W Greene, Barry M. Kaplan, Perkins Coie, Seattle, WA, for Kellett Partners LP, Stiles A Kellett, Jr, Defendants.

Arthur W. Harrigan, Jr., Danielson Harrigan & Tollefson, Seattle, WA, G. Val Tollefson, Danielson Harrigan & Tollefson, Seattle, WA, for Anuradha Jain, Defendant.

Jonathan P Meier, Stephen John Sirianni, Richard E. Spoonemore, Sirianni & Youtz, Seattle, WA, for Thomas R Dreiling, Plaintiff.

ORDER ON CROSS-MOTIONS FOR SUMMARY JUDGMENT

PECHMAN, District Judge.

This matter comes before the Court on cross-motions for summary judgment. (Dkt.Nos.68, 82.) Plaintiff

alleges that the Jain Defendants engaged in prohibited short-swing trades of InfoSpace stock by *1217 transferring shares from the Defendant trusts to personal and escrow accounts. Because these transfers are purchases for purposes of determining short-swing trades, Plaintiff's motion for summary judgment is GRANTED and Defendants' motion for summary judgment is DENIED.

## BACKGROUND

This is a suit by a shareholder of InfoSpace, Mr. Dreiling, against numerous insider Defendants, alleging that the insiders engaged in unlawful short swing trading-the purchase and sale (or vice versa) of stock within a six month period. There are two groups of Defendants in this matter: the Jain Defendants and the Kellett Defendants. The Kellett Defendants have settled the claims against them. (Dkt. No. 133.) Currently before the Court are cross-motions for summary judgment on Plaintiff's claims against the Jain Defendants. The Jain Defendants are the Naveen Jain, a founder and former CEO of InfoSpace, Anuradha Jain, and three trusts established by the Jains for the benefit of their children.

This litigation arises from stock transfers from three trusts established by the Jains in mid-1998: the Naveen Jain Grantor Retained Annuity Trust No. 1 ("NJGRAT"), the Anuradha Jain GRAT ("AJGRAT"), and the Jain Family Irrevocable Trust ("Family Trust"). The Jains established these trusts for tax purposes. Each of the two GRATs were initially funded with two million shares of InfoSpace stock. The Family Trust purchased one million shares of InfoSpace stock from the Jains. Naveen Jain's broth-

er, Atul Jain, was named as the trustee of both GRATs. The GRATs are irrevocable, and the Jains receive annual annuities from the GRATs. Under the terms of the GRATs, the trustee is the owner of the trust estate The remainder of the trust estate of the GRATs is paid out to the Jains' children after the Jains' death. Unlike the GRAT, the Family Trust pays no annuity and the sole beneficiaries are the Jains' children.

Plaintiff alleges that the Jain Defendants engaged in four purchases that subject them to liability for short-swing trades. The first purchase allegedly occurred in December 1998, when Mr. Jain took one million InfoSpace shares from a trust and placed this stock in escrow to satisfy a personal indemnity obligation. The second, third, and fourth purchases took place in May 1999, when the Jains deposited trust shares into their personal trading accounts. Defendants argue that the above transactions were not "purchases," as they are understood under securities law.

The first alleged purchase in December 1998 occurred when Mr. Jain agreed to place in escrow one million shares of his InfoSpace stock. As InfoSpace was preparing for its initial public offering ("IPO") in late 1998, the Board of Directors learned that Mr. Jain might have incurred liability on behalf of InfoSpace through option grants and disputes arising out of commercial contracts. InfoSpace hired the law firm PerkinsCoie to investigate, and the Board later required Mr. Jain to personally indemnify the company for potential claims by placing one million shares of his InfoSpace stock in escrow. Mr. Jain executed an agreement with InfoSpace to establish an

escrow, with InfoSpace as the escrow agent. PerkinsCoie drafted a Securities and Exchange Commission ("SEC") amendment filed on behalf of InfoSpace. (Spoonemore Decl. Ex. 24.) This filing represented that Mr. Jain had placed one million shares of common stock held by the NJGRAT trust in escrow, and that Mr. Jain retained voting control over those shares. (*Id.* Ex. 25.) Because the NJGRAT trust is irrevocable, Mr. Jain had no authority to transfer these shares.

*1218 Over the next year, Mr. Jain signed, or authorized his attorney in fact to sign, numerous SEC filings representing that he had placed the NJGRAT shares in escrow. (*Id.* Exs. 25-34.) A year later, after no claims were made against InfoSpace for Mr. Jain's actions, Mr. Jain requested that the Board release the escrowed shares. In early 2000, the Board officially released Mr. Jain from the indemnity agreement and the shares from escrow. Plaintiff alleges that the escrow agreement was an unlawful transfer of shares to Mr. Jain from the NJGRAT, triggering liability for short swing trades. Defendants contend that no escrow was ever in fact created. Despite the SEC filings, Mr. Jain states that neither he nor InfoSpace officially established the escrow. Defendants' attorneys in this matter, PerkinsCoie, states that it "is not clear why those [reporting] mistakes [to the SEC] were made." (Def's Resp. at 6.) Defendants produce statements from numerous other witnesses testifying to their lack of knowledge of an escrow account.

The other alleged purchases in May 1999 occurred when the Jains deposited shares of the trusts into their personal brokerage accounts. In May 1999, In-

foSpace stock split two-for-one. InfoSpace then issued new stock certificates representing the new shares and sent these certificates to its shareholders. The NJGRAT and AJGRAT split share certificates were sent to InfoSpace's office, while the Family Trust split share certificate was sent to the Jains' home. These stock certificates were marked on their face as belonging to the trusts. Although the trust accounts were held by Banc of America Securities, the Jains sent the shares to their personal broker at Hambrecht & Quist ("H & Q").[1] H & Q deposited the Family Trust shares in the Jains' personal account. H & Q then sent the Jains a draft letter of authorization that would "gift" the GRAT split shares to the Jains. After the Jains filled out these forms and returned them to H & Q, the shares were deposited into the personal trading accounts of the Jains. The Jains held and controlled these shares, for example by voting on them, until 2000, when it is alleged this "transfer error" was discovered. The Family Trust shares were reconveyed to the trust in May 2000. An InfoSpace paralegal who was responsible for tracking shares noticed a discrepancy in the Jains' account. (Haberly Dep. at 14-15.) However, Mr. Jain states that he initiated the request that InfoSpace undertake an internal investigation to determine what stock was held in each account, thereby identifying the transfer error. As a result of the investigation, the split shares were transferred back to the GRATs in December 2000.

The Jains claim that the transfers were innocent

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[1] The record is confused regarding whether Nationsbanc or Banc of America was the holder at the time.

mistaken deposits. Mr. Jain states that he mistakenly believed that the Jain Trusts maintained accounts at H & Q. The Jains declare that they did not know that signing the letters of authorization would effect a gift of shares from the GRATs to their personal trading accounts. Because they did not read their brokerage statements, the Jains claim they were not aware of the transfers.

## ANALYSIS

The parties stipulated to presenting the issues in this case before the Court on cross-motions for summary judgment. (Dkt. No. 50.)Summary judgment is not warranted if a material issue of fact exists for trial. ***1219** *Warren v. City of Carlsbad,* 58 F.3d 439, 441 (9th Cir.1995), *cert. denied,* 516 U.S. 1171, 116 S.Ct. 1261, 134 L.Ed.2d 209 (1996). The underlying facts are viewed in the light most favorable to the party opposing the motion. *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.,* 475 U.S. 574, 587, 106 S.Ct. 1348, 89 L.Ed.2d 538 (1986). "Summary judgment will not lie if ... the evidence is such that a reasonable jury could return a verdict for the nonmoving party." *Anderson v. Liberty Lobby, Inc.,* 477 U.S. 242, 248, 106 S.Ct. 2505, 91 L.Ed.2d 202 (1986). The party moving for summary judgment has the burden to show initially the absence of a genuine issue concerning any material fact. *Adickes v. S.H. Kress & Co.,* 398 U.S. 144, 159, 90 S.Ct. 1598, 26 L.Ed.2d 142 (1970). However, once the moving party has met its initial burden, the burden shifts to the nonmoving party to establish the existence of an element essential to that party's case, and on which that party will bear the burden of proof at trial. *Celotex Corp. v. Catrett,* 477 U.S. 317, 323-24, 106 S.Ct. 2548, 91

L.Ed.2d 265 (1986). To discharge this burden, the nonmoving party cannot rely on its pleadings, but instead must have evidence showing that there is a genuine issue for trial. *Id.* at 324, 106 S.Ct. 2548.

Section 16(b) of the 1934 Securities and Exchange Act contains a blanket prohibition on insiders engaging in short-swing trades-purchasing and selling (or vice versa) within a six-month window. 15 U.S.C. § 78p(b). This is a bright-line rule designed to combat the possibility of unfair insider trading. An insider may be a corporate officer, director or 10% shareholder. *Id.* at (a)(1). If any corporate insider engages in short-swing trades, a shareholder may bring suit on behalf of the company, forcing the insider to disgorge all profits to the company. *Id.* at (b). The principal issue raised in the cross-motions for summary judgment is the legal question of whether the trust transactions are purchases under federal securities law. Defendants make three basic arguments: (1) because the transfers from trusts to personal or escrow accounts did not constitute a change of beneficial ownership of the InfoSpace shares, none of the four disputed transactions was a purchase; (2) while the transfers from the trust to personal and escrow accounts may be mistakes or gifts, they are not purchases; (3) since no escrow was ever in fact established, Mr. Jain never purchased the InfoSpace that were to be placed in escrow.

[1] It should be noted that Defendants' protests of innocent intentions are largely irrelevant since Section 16(b) imposes strict liability for short-swing trades. The statute requires disgorgement to the company of any profit derived from the matching of any purchase and any sale of an "equity security"

within a six-month period by a statutory insider, irrespective of intent. *Gwozdzinsky v. Zell/Chilmark Fund, L.P.*, 156 F.3d 305, 308 (2d Cir.1998). "No showing of actual misuse of inside information or of unlawful intent is necessary to compel disgorgement." *Magma Power Co. v. Dow Chem. Co.*, 136 F.3d 316, 320 (2d Cir.1998). Rather, Section 16(b) "operates mechanically, and makes no moral distinctions, penalizing technical violators of pure heart, and bypassing corrupt insiders who skirt the letter of the prohibition." *Id.* at 320-21. The statute, therefore, "imposes liability without fault ... within its narrowly drawn limits." *Id.* at 321.

*I. Change in Beneficial Ownership*

[2] Section 16 liability for short-swing trades does not attach if the owner of a stock merely changes his or her form of ownership. Such a transaction is not a purchase, but a mere change in beneficial ownership. Changes in beneficial ownership are exempted from Section 16(b) liability.***1220** 17 C.F.R. § 240.16a-13. Defendants argue that all four transfers from the trusts to personal and escrow accounts were mere changes in the form of beneficial ownership. Plaintiff argues that the Jain Defendants did not have beneficial ownership of the stock in any of the trusts.

The general definition of "beneficial owner" is broad, and Defendants urge the Court to interpret the definition to include persons such as the Jains who receive annuities from a trust:

[T]he term beneficial owner shall mean any person who, directly or indirectly, through any contract, arrangement, understanding, relationship or other-

wise, has or shares a direct or indirect pecuniary interest in the equity securities, subject to the following.

(i) The term pecuniary interest in any class of equity securities shall mean the opportunity, directly or indirectly, to profit or share in any profit derived from a transaction in the subject securities.

Rule 16a-1(a)(2). However, the regulations refer to another section to determine how to analyze beneficial ownership in the specific context of trusts.
(ii) The term indirect pecuniary interest in any class of equity securities shall include, but not be limited to:

. . . . .

(E) A person's interest in securities held by a trust, *as specified in § 240.16a-8(b).*

Rule 16a-1(a)(2) (emphasis added). Rule 16a-8 spells out how to analyze trust ownership.

The "settlor" or founder of the trust is considered the beneficial owner "where they have the power to revoke the trust without the consent of another person." Rule 16a-8(a)(2)(ii). There is no dispute that the Jains did not have the power to revoke the trusts, therefore the fact that they are settlors does not make them beneficial owners.

The beneficiary of the trust is considered a beneficial owner in a number of circumstances:

(3) Beneficiaries. A beneficiary subject to section 16

of the Act shall have or share reporting obligations with respect to transactions in the issuer's securities held by the trust, if the beneficiary is a beneficial owner of the securities pursuant to § 240.16a-1(a)(2), as follows:

(i) If a beneficiary *shares investment control* with the trustee with respect to a trust transaction, the transaction shall be attributed to and reported by both the beneficiary and the trust;

(ii) If a beneficiary *has investment control* with respect to a trust transaction without consultation with the trustee, the transaction shall be attributed to and reported by the beneficiary only;

Rule 16a-8(b) (emphasis added). The Jains do not fall under either of the above categories. Although the Jains received annuity payments, they did not control the trust or share investment control with the trustee. Therefore, the Jains were not beneficial owners of the trust.

Treatises and case law agree that the above analysis directs the determination of beneficial ownership of trusts for purposes of Section 16 liability. *See Feder v. Frost,* 220 F.3d 29 (2d Cir.2000); Bloomenthal & Wolff, 3D *Securities and Federal Corporate Law* § 21.26 at 21-40 (2d ed 2002) ("Beneficiaries of a trust generally will not have the requisite voting or investment control to be beneficial owners for the purpose of determining insider status."), Loss & Seligman, V *Securities Regulation* at 2425 n. 169 (3d ed.2001). For example, a beneficiary has been held liable under Section 16 when he "purchased" shares with an IOU from a trust of which he was a benefi-

ciary. *1221*Morales v. Quintiles Transnational Corp.*, 25 F.Supp.2d 369 (S.D.N.Y.1998). A transfer of InfoSpace shares from the trust to the Jains' personal accounts is a change in beneficial ownership

The public policy underlying the reporting and beneficiary ownership rules on trusts further bolsters Plaintiff's position. If the Jains did not control investment decisions of the trust, or even have reason to know of the transactions the trustee made, then it would be unfair to count such transactions as purchases or sales of the Jains. On the other hand, if the Jains maintained control over the investment decisions of the trusts and benefitted from those transactions, then the trusts' purchases and sales should be counted as the Jains. Loss & Seligman, V *Securities Regulation* at 2425-26 ("Where investment control is shared, including consultation between the trustee and beneficiary, both the trust and the beneficiary must report the transaction and are responsible for any resulting short-swing profits") (citing Sec. Ex. Act. Rel. 28,869 (1991)). Here, because the Jains did not exercise investment control over the trusts, they are not beneficial owners of the shares of the trusts. Normally, this policy operates to protect non-controlling trust beneficiaries from short-swing liability for trust transactions. In this case, however, the transactions at issue were not solely within the corpus of the trusts, but rather a transfer from the trusts to the Jains. Therefore, the Jains' transfer of shares from the NJGRAT, AJGRAT, and Family Trust to their personal trading accounts constituted a change in beneficial ownership. Also, transfer of stock from the NJGRAT trust to an escrow account to satisfy a personal obligation of Mr. Jain effected a change in beneficial ownership.

The above analysis disposes of two additional issues raised by the Defendants. Because the Jain Defendants admit that they did not report the "misdeposits" from the trusts to their personal accounts that effected a change in beneficial ownership, the statute of limitations is tolled. *Whittaker v. Whittaker*, 639 F.2d 516, 528 (9th Cir.1981), *cert denied*, 454 U.S. 1031, 102 S.Ct. 566, 70 L.Ed.2d 473 (1981); (Def.'s Resp. at 13). While the shares owned by one's spouse or children may be counted as one's own for purposes of being an insider, the above rules on trusts establish that the Jains are not the beneficial owners of the holdings of the trusts.

*II. Stock Transfers from the Trusts as Purchases*

[3] The term "purchase" is defined in Section 3 of the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(13), to include "any contract to buy, purchase, or otherwise acquire." Questions often arise as to whether a particular transaction qualifies as a "purchase" or "sale" within the meaning of the statute. Courts have answered this question by applying essentially two types of analysis. For transactions which are ordinary (e.g. cash for stock) "purchases" or "sales," generally referred to as "orthodox" transactions, Section 16(b) has been strictly applied, using an "objective" analysis. *See Whittaker*, 639 F.2d at 522. Therefore, in an "orthodox" transaction, Plaintiff need not show any possibility for speculative abuse-it is presumed. For transactions which are not ordinary "purchases" or "sales," generally termed "unorthodox" or "borderline" transactions, courts have developed a "pragmatic" or "subjective" analysis to test whether the transaction is of the type that Congress sought to prohibit. *Id.* Plaintiff argues

that all four stock transfers from the trusts to personal or escrow accounts are "purchases" under both the orthodox and unorthodox analysis. Defendants contend that the 1999 stock transfers from the trusts to the Jains' personal accounts were *1222 not purchases because there was no possibility of speculative abuse. Even if an escrow was created, Defendants contend that transfer of shares from the NJGRAT trust to the escrow also created no possibility of speculative abuse, and therefore is not a purchase.

*A. Choosing the Analysis*

There is no clear rule that the Court may apply in this case to determine whether to apply the orthodox or unorthodox test. *See Prager v. Sylvestri,* 449 F.Supp. 425, 430 n. 6 (S.D.N.Y.1978) ("The distinction between borderline or unorthodox transactions and garden-variety [or orthodox] ones is not overly bright."). It is clear to the Court, however, that the alleged purchases here are distinct from the archetypical case of stock-for-cash trades and appropriately categorized as borderline.

First, there was no obvious "purchase" in the sense of an exchange of stock for consideration. This lack of consideration may or may not be fatal to the argument that there was a purchase. As one commentator has noted.

[C]ertain transactions involving no consideration are not a purchase or a sale under Section 16(b): Gifts, stock splits, stock dividends, and receipt of rights distributed to all stockholders pursuant to preemptive rights. Notwithstanding these Section 16(b) cas-

es, transferring a security without receiving consideration could be a Section 16(b) purchase and sale under the proper circumstances. Whether or not a transfer for no consideration is a purchase and a sale, transfers for worthless consideration or inadequate consideration can be Section 16(b) purchases and sales.

Jacobs, *Disclosure & Remedies Under the Securities Laws* § 4:157 (2002). The fact that a transfer with no consideration may or may not be a violation of Section 16(b) raises the considerations of the "unorthodox" analysis. Also, the Ninth Circuit has treated an "overissue" of stock-stock transferred in error-under the unorthodox analysis. *Kay v. Scientex Corp.*, 719 F.2d 1009, 1011-12 (9th Cir.1983). This is the closest case that the parties cite to the transaction at issue here, and the Court considers an erroneous overissue to be similar to the alleged erroneous transfers. Because not every allegedly erroneous transfer could be considered to be an orthodox transaction, it is appropriate to analyze the transactions at issue in this matter under the unorthodox rule.

*B. Unorthodox analysis*

[4] The Supreme Court has taught that the focus of the unorthodox test should be whether the transaction at issue threatens speculative abuse:

Where alternative constructions of the terms of Section 16(b) are possible, those terms are to be given the construction that best serves the congressional purpose of curbing short-swing speculation by corporate insiders. Thus, in interpreting the terms 'purchase' and 'sale,' courts have properly asked whether

the particular type of transaction involved is one that gives rise to speculative abuse.

*Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 593, 93 S.Ct. 1736, 36 L.Ed.2d 503 (1973). In considering whether the type of transaction at issue gives rise to the potential for speculative abuse, two factors are of primary importance: (1) access to inside information; and (2) the ability to influence the timing of a transaction. *Morales v. Gould Investors Trust*, 445 F.Supp. 1144, 1153 (S.D.N.Y.1977), *aff'd*, 578 F.2d 1369 (2d Cir.1978).

Applying *Kern*, the Ninth Circuit has also emphasized that "involuntariness" is an important factor in determining whether***1223** or not a transaction constitutes a "sale" or "purchase" under Section 16(b). *Colan v. Mesa Petroleum Co.*, 951 F.2d 1512, 1522 (9th Cir.1991). The Supreme Court in *Kern* noted not just the lack of a possibility of speculative abuse, but also that the defendant-a company undergoing a merger-had no control over the stock transactions. The Ninth Circuit has effectively made involuntariness into a second requirement for passing the unorthodox test. "Absent a showing of involuntariness, we would not be justified in applying the Kern County rule." *Id.* The Ninth Circuit in *Kay* recited very strong language on voluntariness.

In determining whether the overissuance of shares is a purchase within the meaning of section 16(b) we find it appropriate to inquire into the voluntary nature of the transaction. If an overissuance of stock is done *entirely without participation* by the recipient of the stock it is doubtful the transaction presents the opportunity for speculative abuse condemned by

section 16(b). If, however, the recipient is *instrumental in the overissuance,* the opportunity for speculative abuse is present.

719 F.2d 1009, 1013 (emphasis added). Other courts have also applied extremely narrow definitions of voluntariness: "Case law establishes a stiff test of voluntariness. So long as the seller retains *any degree of control* over a transaction, its actions will not be found to be involuntary." *Sprague Elec. Co. v. Mostek Corp.,* 488 F.Supp. 842, 845 (N.D.Tex.1980) (emphasis added). Accordingly, the Court evaluates whether the Jains' transactions were neither voluntary nor likely to lead to speculative abuse.

*1. Voluntariness*

The Jain Defendants' actions were voluntary. The Jains signed papers allowing transfer of funds from the GRATs. The Jains caused deposits of trust stock into their personal brokerage accounts by forwarding stock certificates to their personal broker. Mr. Jain promised to place shares of the NJGRAT trust into escrow to fulfill a personal obligation. The fact that the Jains failed to read their brokerage statements, simply signed legal documents without knowing what they were, and mistakenly sent certificates to their personal broker does not make their actions involuntary. As noted above, their subjective intention is not relevant to a Rule 16(b) analysis. The Jain Defendants are correct that their actions are "less voluntary" than those in the *Kay* overissue case. *See* 719 F.2d at 1013. Nonetheless, the Jains participated in the transfers and retained more than a degree of control over the transactions. Without the participation of the Jains, the transfers would not

have happened. While the Jains' actions in effecting the transfers may not have been culpable, they were voluntary.

*2. Possibility of Speculative Abuse*

The Jains' transfer of shares to their personal accounts created the possibility of speculative abuse. The Jains had insider knowledge and influence over the timing of the transfers. Again, it does not matter what the Jains intended or what speculative actions they actually took. Rather, it is clear that the transfer of literally millions of shares to a personal account created the possibility of speculative abuse. The Jains could have sold the shares at a high price, repurchased the shares at a lower price, and then transferred the shares back to the trusts. The transfers created the possibility of selling, or "freeing up" for sale, the Jains' personal shares. The *Kay* court found as a matter of law that acquisition through an erroneous overissuance and consequent sale for cash demonstrated the possibility of speculative abuse: "When insiders participate in voluntary acquisitions of stock coupled with conventional sales, the possibility of speculative***1224** abuse of insider information is present. Neither proof of actual abuse of insider information nor proof of intent to profit on the basis of such information is necessary under section 16(b)." 719 F.2d at 1013. Plaintiff demonstrates both voluntariness and the possibility of speculative abuse.

*C. Gifting*

[5] Defendants argue that the transfers may be characterized as gifts. Bona fide gifts are exempted from

Section 16(b). Rule 16b-5 ("Both the acquisition and the disposition of equity securities shall be exempt from the operation of Section 16(b) of the [Exchange] Act if they are bona fide gifts."). Gifts are not sales or purchases when made in good faith and without subterfuge. *See Shaw v. Dreyfus,* 172 F.2d 140, 142-43 (2d Cir.1949), *cert. denied,* 337 U.S. 907, 69 S.Ct. 1048, 93 L.Ed. 1719 (1949).

There is no evidence that the trusts gifted the shares, or had the authority to gift the shares, to the Jain Defendants. There is no evidence that the Jain Defendants had the power or authority to gift the trust shares to themselves. An allegedly erroneous transfer cannot be reclassified as a gift to escape liability for short-swing trades.

Because the Jains' transfers of stock in 1999 from the NJGRAT, AJGRAT, and Family trust were voluntary and created the possibility of speculative abuse, they constitute purchases for purposes of Section 16(b) liability. Mr. Jain's placement of NJGRAT shares into an escrow account also was voluntary and created the possibility for speculative abuse, and therefore it is a purchase.

*III. Existence of the Escrow Account*

[6] Defendants insist that the escrow account of the one million InfoSpace shares from the NJGRAT was never in fact established. Plaintiff argues that the SEC filings and actions of the parties demonstrate the existence of the escrow.

On December 11, 1998, Mr. Jain and InfoSpace executed an indemnification agreement to establish

the escrow fund at issue. (Spoonemore Decl. Ex. 23 at 1, 4.) That same day, Mr. Jain was to deliver "to the Escrow Agent certificates representing 1,000,000 shares of the Company's Common Stock ..." (*Id.* at 4.) The agreement appointed InfoSpace as the escrow agent. (*Id.* at 9.) The agreement stated that Mr. Jain was to have the right to vote the escrowed stock and receive cash dividends, while the escrow agent had the right to possess the escrowed stock. (*Id.* at 4.)

The agreement is governed by Washington law. (*Id.* at 10.) In Washington, an escrow is defined as a transaction:

wherein any person or persons, for the purpose of effecting and closing the sale, purchase, exchange, transfer, encumbrance, or lease of real or personal property to another person or persons, delivers any written instrument, money, evidence of title to real or personal property, or other thing of value to a third person to be held by such third person until the happening of a specified event or the performance of a prescribed condition or conditions, when it is then to be delivered by such third person, in compliance with instructions under which he or she is to act, to a grantee, grantor, promisee, promisor, obligee, obligor, lessee, lessor, bailee, bailor, or any agent or employee thereof.

RCW 18.44.011(4). The escrow agreement between Mr. Jain and InfoSpace reflects the encumbrance and transfer of the personal property of one million shares. The escrow provisions of the agreement did not specify which third person was to hold the stock certificates or where the certificate *1225 would be held. The Court does not find it unusual, however,

that the attorneys for InfoSpace, PerkinsCoie, would hold the certificates. *See FDIC v. Knostman,* 966 F.2d 1133, 1140 (7th Cir.1992). Neither does the failure to identify a third party nor the fact that PerkinsCoie already had possession of the certificates at the time of the agreement's execution prevent formation of the escrow. *See id.* at 1140-41. It is clear that the parties intended and agreed to encumber the personal property and establish an escrow. *Cf.* Stoebuck, 17 *Wash. Prac., Real Estate: Property Law* § 7.11 ("delivery" means "intent." It is possible, and Washington has so held, "for a deed to be delivered though it remains in the grantor's possession, provided his intent that it shall pass title is clearly shown.") The terms of the escrow are not in dispute. Mr. Jain and InfoSpace, with the assistance of PerkinsCoie, represented to the SEC that the NJGRAT shares were placed into escrow. It is undisputed that PerkinsCoie held the certificates when Mr. Jain and InfoSpace signed the agreement. These actions formed an escrow.

Additionally, the Court agrees with Plaintiff that Mr. Jain's pledge of NJGRAT shares created the possibility of speculative abuse. Through the pledge of the NJGRAT shares, Mr. Jain avoided pledging stock he already owned, thereby gaining an opportunity to trade a million shares that otherwise would have been encumbered. Mr. Jain incurred no risk that the one million shares from the NJGRAT would decrease in value, since he did not pay for the shares on their transfer. Because Mr. Jain placed in escrow one million shares of the NJGRAT, he effected a purchase for purposes of liability under Section 16(b).

*IV. Motion to Strike Expert Report*

Plaintiff moves to strike Defendant's expert report. Defendants' expert report on securities law does not assist the Court in resolving the cross-motions. Accordingly, Plaintiff's motion to strike is DENIED as MOOT.

CONCLUSION

Because the transfers at issue in this matter are purchases for purposes of determining short-swing trades, Plaintiff's motion for summary judgment is GRANTED and Defendants' motion for summary judgment is DENIED.

ORDER DENYING DEFENDANTS' MOTIONS FOR RECONSIDERATION

This matter comes before the Court on Defendants' motions for reconsideration. Defendant Naveen Jain moves for reconsideration of this Court's order on summary judgment, (Dkt. No. 157), as do the Jain Trusts and Anuradha Jain, (Dkt. No. 159). Defendants contend that the Court erred in concluding that Defendants are liable under Section 16(b) for trust transactions because: (1) the trustee can rescind the stock transfers and therefore avoid Section 16(b) liability; and (2) no escrow was created. The Jain Trusts also move for a Rule 56(f) continuance to conduct discovery to support an additional motion for reconsideration, which would be filed after the ten day deadline for reconsideration motions. (Dkt. No. 152.)

Motions for reconsideration are disfavored. Local

Rule CR 7(h)(1). The court will ordinarily deny such motions in the absence of a showing of manifest error in the prior ruling or a showing of new facts or legal authority which could not have been brought to its attention earlier with reasonable diligence. *Id.* The Court disagrees with Defendants' contentions of manifest error, and accordingly Defendants motions for reconsideration are DENIED. Because Defendant has failed to demonstrate grounds for a late Rule 56(f) ***1226** continuance, Defendants' motion is DENIED.

*I. Rescission*

Defendants argue that the trustee can rescind any transfers from the trusts to the Jains on the grounds that such transfers were invalid because the trustee never approved them. Rescission, Defendants argue, eliminates Section 16(b) liability.

First, this is an inappropriate new argument, and Defendants have failed to show why this issue could not have been raised on the cross-motions for summary judgment. *Rosenfeld v. United States Dep't of Justice,* 57 F.3d 803, 811 (9th Cir.1995). The fact that Defendants hired new counsel after losing on summary judgment is not by itself justification for raising new issues on reconsideration and effectively relitigating the prior order.

Second, the Court does not agree on the existence of a broad rule eliminating invalid, later rescinded transactions from Section 16(b) liability. *See Oliff v. Exchange Int'l Corp.,* 449 F.Supp. 1277, 1291 (N.D.Ill.1978) ("The issue is thus not whether a rescission took place but whether the particular rescis-

sion constituted a purchase within the meaning of section 16(b)."). If Section 16(b) liability could be avoided by rescission, then all potential defendants in such actions could simply rescind in the face of a lawsuit. The mere fact that a transfer is invalid does not insulate a person from Section 16(b) liability. *See Kay v. Scientex Corp.*, 719 F.2d 1009, 1013-14 (9th Cir.1983). The cases that Defendants cite are very narrow exceptions where courts found that rescission demonstrated that there was, in fact, no transaction and no threat of speculative abuse. *See Oliff,* 449 F.Supp. at 1291-93 (analyzing cases on rescission). Here, in contrast, Plaintiff demonstrated the possibility of speculative abuse.

*II. Escrow*

Defendant Naveen Jain contends that there is at least a fact issue regarding whether or not an escrow exists. In its Order on the cross-motions for summary judgment, the Court considered the evidence presented by Defendant and concluded that it demonstrated the existence of an escrow. Defendant makes two principle arguments on the escrow issue: (1) that Perkins Coie did not agree to be an escrow agent; and (2) that the SEC filings contained contradictory information supporting the inference that no escrow was created.

Having examined the original briefing on the escrow issue, again the Court finds that both arguments Defendant raises on reconsideration to be new, and therefore inappropriately raised. *Rosenfeld,* 57 F.3d at 811. Nonetheless, the Court does not agree with Defendant's contentions. Defendant argues that Perkins Coie had to agree to be an "escrow agent" to

the transaction in order for the escrow to exist, but cites a 1973 District of Columbia Court of Appeals case for the proposition. (Jain Recon. at 2.) Regardless, the terms of the escrow agreement name InfoSpace as the escrow agent. InfoSpace's counsel, Perkins Coie, had possession of the shares and clearly knew of the agreement. The Court found these undisputed facts sufficient for establishing the existence of an escrow.

Defendant also contends that SEC filings are contradictory. In several cases the filings indicate that Mr. Jain "has agreed" to escrow "beneficially owned" shares, whereas in another the filing states that Mr. Jain had established the escrow with trust shares. The Court does not believe that these differences create an issue of fact. The actions of the parties demonstrate the existence of the escrow. Defendant's motion for reconsideration is DENIED.

**1227 III. Rule 56(f) Continuance*

The Jain Trust Defendants seek a Rule 56(f) continuance in order to discover information regarding the formation of an escrow and transfer of trust assets. On obtaining this information, Defendants seek to file an additional motion for reconsideration past the ten day deadline.

A Rule 56(f) motion must be brought before the summary judgment hearing. *United States v. Kitsap Physicians Service,* 314 F.3d 995, 1000 (9th Cir.2002), *citing Ashton-Tate Corp. v. Ross,* 916 F.2d 516, 520 (9th Cir.1990). While other jurisdiction may have recognized exceptions to this rule, Defendants have failed to demonstrate why any exception should

apply here.

Although Defendants contend that the Court made an "unexpected finding" regarding the existence of the escrow, and in particular concerning the actions of Perkins Coie, these issues were argued and briefed by the parties. (*See,* e.g., Pl.'s Mot. Summ. J. at 12) ("Perkins Coie certainly knew that those shares were subject to escrow-it was the very entity that, in drafting the public filings, inserted the statements that the NJGRAT shares had been placed into escrow."). The existence of the escrow was a critical issue on summary judgment, and the Court agreed with the arguments advanced by Plaintiff. Moreover, the parties engaged in significant discovery for nearly a year before submitting cross-motions for summary judgment to the Court. The briefs on the cross-motions for summary judgment were submitted, by stipulation of the parties and order of the Court, past the deadline for dispositive motions. The Court extended the deadline after the parties represented that they expected no trial would be necessary and that the case could be resolved as a matter of law. Defendants' change of attorneys is not grounds for a continuation.

Having failed to show manifest error to the Court, Defendants motions for reconsideration are DENIED. Because Defendant has failed to demonstrate grounds for a late Rule 56(f) continuance, Defendants' motion is DENIED.

W.D.Wash.,2003.
Dreiling ex rel. Infospace, Inc. v. Kellett
281 F.Supp.2d 1215